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Meaning and Significance of Auditing

The system of checking records of financial transactions in a very rudimentary form may be traced back to ancient times when civilisation had developed to a stage where people carried on business transactions But such checking or audit was confined mainly to the public accounts (Historical records show that the ancient Egyptians, the Greeks and the Romans used to get public accounts audited

Evidences of the use of private audit in the early stages of civilisation are rare. It is probably because the transactions were small in number and every individual was able to record and check them himself With the expansion of business, the transactions became so numerous that it was not possible for a man to devote himself to conducting as well as recording them He, therefore, started taking the services of others for recording those transactions This segregation necessitated the application of some system of check upon those persons who recorded such transactions on behalf of others

Auditing, as it exists today, developed quite late because the development of accounting was slow as compared to economic theory, finance and the business conduct It was in 1494 that Luca Pacioli, an Italian mathematician, first published his comprehensive treatise on principles of double entry He also described the duties and responsibilities of an auditor Use of principles of double entry made it possible to record not only cash but all sorts of mercantile transactions It had a profound impact on auditing too, as it enhanced the duties of an auditor to a marked extent) During the sixteenth, seventeenth and eighteenth centuries, accounting developed slowly but in keeping with economic theory and business practice Public accountant came into picture late in the eighteenth century but they were not experts and were merely letter-writers or copyists

It was in the later part of the nineteenth century that auditing started taking firm root in the modern sense' During this period several treatises and texts on accounting were published Besides, tremendous industrial development was also taking place Invention of steam and mechanisation of industry facilitated production on a very large scale and led to the introduction of the factory system This increased the demand for capital to such an extent that it was not possible for a sole proprietor or a partnership firm to provide the

same The result was the establishment of joint stock companies with limited liability of the shareholders. Under the company form of organisation, it is not possible for all the shareholders to participate in its management They delegate its management to a Board of directors The Board presents the accounts of the company to the shareholders periodically It resulted into separation of management from ownership This necessitated the adoption of some means of check by which the shareholders, as a body, might be able to satisfy themselves with regard to the truth and fairness of the financial position and earnings of the company as presented to them by the Board of Directors The shareholders themselves were not in a position to do so In the beginning, a shareholder was appointed as an auditor of the company to check its accounts but it could not serve any useful purpose as he lacked technical knowledge, experience, or ability for such work Hence, the custom for the appointment of professional auditors developed.

With the rapid increase in the number of companies in the present century, this profession has assumed an ever increasing role in the business community. It was so because the auditor played a vital role in instilling confidence in the public at large with regard to company form of organisation by revealing the facts to them and imposing a check upon the management Its strides forward have been tremendous since the various countries passed company legislation with provisions making the audit of joint stock companies compulsory. This turned out to be instrumental in establishing it as a major profession This trend was also reinforced by other statutory enactments

In England, the Companies Act, 1900 first made it legally compulsory for every company to appoint auditors In India, the Companies Act, 1913 provided for the compulsory audit of the companies for the first time and prescribed the qualifications of a company auditor. Consequently, the accounting profession developed since then The Provincial Governments were authorised to issue certificates to accountants entitling them to act as auditors. The Bombay Government was pioneer in the field and started a diploma in accountancy, known as Government Diploma in Accountancy (G D.A.), which could be obtained by passing the necessary examination. Persons holding such diploma were qualified to act as auditors in any province of the country.

Until 1932, the Provincial Governments had full control over the accountancy profession, but when Auditor's Certificates Rules, 1932 were passed its control and regulations passed from the Provincial Governments to the Central Government in order to maintain uniform set of standards throughout the country Under these Rules persons who wanted to obtain necessary qualifications for auditing had to obtain a certificate of Registered Accountants (R A) For this purpose, the Central Government started maintaining a *Register*

of Accountants An Indian Accountancy Board was also established under the rules

The Central Government had full control over the profession upto 1949 During the period there was marked growth in the accountancy profession and the demand for its autonomy grew day by day In 1949, the Chartered Accountants Act was passed and since then full autonomy has been granted to the profession as the control, regulation and the management of the profession has now passed from the Central Government to the profession

For this purpose, an Institute of Chartered Accountants of India was established by an Act of Parliament It came into existence on July 1, 1949 Besides regulating the profession, it also conducts examinations, grants Certificate of Practice and exercises disciplinary jurisdiction over its members The affairs of the Institute are managed by a Council consisting of 27 members of whom 21 are elected and 6 are nominated by the Government of India It has its headquarters at New Delhi and regional offices at Bombay, Calcutta, Delhi, Madras, Kanpur and branches of regional offices at Ahmedabad, Baroda, Bangalore, Coimbatore, Ernakulam, Hyderabad, Jaipur, Madurai and Poona It is to be noted that in 1949, when it was established, the chartered accountants registered with it were only 1,600 but now their number is over 3,000 The Institute occupies an unique position as even in the more advanced countries like the U K and U S A the professional accounting bodies do not perform all the functions performed by it "Apart from the traditional areas of financial audit and taxation, the professional accountants have entered new areas of service like management services, performance and management audit, project planning, financial consultancy, and machine accounting"

After the enactment of Cost and Works Accountant Act in 1959, another body of accountants developed in the country They mainly specialise in Cost Accountancy However, they have also been allowed to carry out cost audit in accordance with the provisions of the Section 233 B of the Companies Act, 1956. It may be noted that the cost audit has been made compulsory for certain specified companies and with that the importance of cost accountants has grown considerably

MAJOR FACTORS INFLUENCING EVOLUTION AND IMPORTANCE OF AUDITING

A general survey of various factors influencing the evolution of auditing has been made as above. Let us analyse them pointwise and briefly.

(i) *Industrial Revolution* The Industrial Revolution brought about tremendous changes in the system of production and distribution and with that the organisational set-up of the business enter-

prises also advanced and changed tremendously. This also increased the size of enterprises enormously This brought about the change in the technique of auditing as thorough and detailed checking of all the accounting records is rather impossible It changed the objects of auditing also It also helped in the emergence of auditing as an independent profession

(ii) *Divorce of Ownership from Management.* As the size of the business enterprises grew, there has been a tendency for the divorce of ownership from the management This necessitated a thorough checking of the records by independent auditor so that the owners may be able to get the clear picture of the working of the concern, managed by others

(iii) *Regulation by the State.* The Governments of all the countries started regulating the concerns considerably to protect the interest of large number of investors Several Acts have been passed in our own country from this point of view The Companies Act, 1956, the Industries (Development and Regulations) Act, 1951, the Capital Issues Control Act, 1947 and the various labour and mercantile laws of the country have been passed which have affected the auditing of the accounts considerably

(iv) *Pronouncements by Court of Law* Judiciary has also influenced and helped the evolution of auditing considerably Off and on, important judgments have been passed by the Court of Law which demanded a change in the attitude of the auditors They have made it easier for the aggrieved party to sue an auditor and make him responsible for negligence They have started demanding, through their judicial pronouncements, for the establishment of "generally accepted accounting principles and auditing standards" Thus, they are playing a very important role in bringing about necessary changes in the practices and standards adopted by the auditors

(v) *Mechanised Accounting* With the growing use of mechanisation, specially, computers, for recording the transactions, there is a growing change in the techniques and practices of auditing. It has necessitated considerable change and a rethinking on the part of auditors Now they cannot entirely depend upon the old tools and techniques of auditing.

(vi) *Regulation by Profession.* This accounting profession is duly regulated in almost all countries of the world In our own country, the Institute of Chartered Accountants is making considerable efforts "to evolve its own standards of education, training, professional expertise, ethics and discipline" This has a marked influence on the growth of auditing.

(vii) *Establishment of International Accounting Standards* Recently, efforts are being made to evolve international accounting standards and this would definitely be a hall-mark in the evolution of

auditing This would bring about uniformity in practices followed by the auditors in various countries of the world For the purpose, International Accounting Standards Committee was constituted The Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India are associate members of the Committee The standards laid down by the committee would be applicable to all the member bodies of various countries, including above Institutes of India

DEFINITION

It is interesting to note the origin of the word 'audit' It has been derived from the Latin word '*audire*', which means 'to hear' In olden days, a person was appointed to check the accounts of the parties responsible for financial transactions He used to call them and hear the explanations needed The person who *heard* the accounts came to be known as an auditor

The most commonly accepted definition of audit is given by *Spicer and Pegler* According to them, an audit is "such as examination of the books, accounts and vouchers of a business, as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of the affairs of the business, and whether the Profit and Loss Account gives a true and fair view of the profit or loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books , and if not, in what respects he is not satisfied "[1] In this definition, the emphasis is on the comparison of Balance Sheet and Accounts with the books "in order to see that they agree therewith" and the auditor has to satisfy himself in this respect According to it, the main objective of an audit is to ascertain the truth and fairness of the state of affairs of the business concerned.

1 Spicer and Pegler, *Practical Auditing*, p 3,

F R M de Paula agrees with Spicer and Pegler to a great extent and asserts that audit "denotes something much wider, namely, the examination of a balance sheet and profit and loss account prepared by others As a result of his examination of the books, accounts, vouchers, etc , and of his inquiries, the auditor must satisfy himself that such balance sheet and profit and loss account are properly drawn up so as to exhibit a true and fair view of the state of the affairs and of the earnings of a particular concern "[1] This definition adds an important point that the accounts are to be prepared by persons other than auditors. If an auditor prepares the accounts, to be audited later on, he acts as an accountant and not as an auditor.

L R Dicksee says, "An audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate. In some instance it may be necessary to ascertain whether the transactions themselves are supported by proper authority."[2] In this case there is greater emphasis on the technique of auditing, but it does not state the objective very clearly There is stress on checking the authority behind the transactions also

Ronald A Irish says , "Auditing in its modern concept, is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the Balance Sheet and the net income revealed by the Profit and Loss Account." This definition lays stress on the fact that audit is a scientific and systematic examination and should not be carried on haphazardly It also points out that after the examination of accounts is complete, a report has to be submitted.

Taylor and Perry have also given the definition of Audit in a precise way in the following words· "An audit is an investigation by an auditor into the evidence from which the final Revenue Accounts and Balance Sheet or other statement of an organisation have been prepared, in order to ascertain that they present a true and fair views of the summarised transactions for the period under review and of the financial state of the organisation at the end date, so enabling the auditor to report thereon " In this definition the object of the auditing has been made clear in simple words

According to *Montgomery*, a leading American accountant, "Auditing is a systematic examination of the books and records of a business or other organisation, in order to ascertain or verify, and to report upon, the facts regarding its financial operations and the results thereof."[3] This definition extends the application of

1. F.R M de Paula, *The Principles of Auditing*, p. 3.
2. L R. Dicksee, *Auditing*, p. 1
3. Quoted in Taylor and Perry, *Principles of Auditing*, p 5.

audit to other organisations also, besides the business concern It also emphasis that audit should be carried on scientifically and systematically and a report has to be submitted disclosing facts, in the end

According to *Eric L Kohler*, an audit is "an exploratory, critical review by a public accountant of the underlying internal controls and accounting records of a business enterprise or other economic unit, precedent to the expression by him of an opinion of the propriety of its financial statements"[1] This definition includes the examination of internal controls by the auditor It also includes in its purview the audit of economic units and not business enterprises alone He further says that "The words of the above definition require no special technical interpretation, they have fairly specific and commonly understood meanings among persons familiar with business operations"

Mautz has laid emphasis on the verification of accounting record and determination of their accuracy and reliability. According to him, auditing is "concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports"[2]

With the enlargement of size and complexity of business enterprises, today, the concept and scope of auditing have changed considerably A more comprehensive definition, relevant to the modern business world, has been given by Robert E Schlosser in the following words Auditing is a "systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principles, management policies or stated requirements"[3] It lays emphasis on the point that auditing does not simply involve examination of financial statements and records but also 'related operations' It has also to be seen as to how far they adhere to "management policies" or "stated requirements" Thus, it reflects the modern trend of auditing and points out that its scope has enlarged considerably

The above definitions reveal certain facts The auditing of books of account of a concern is carried on *in a scientific and systematic manner* The technique of auditing is based on scientific principles It is not carried on haphazardly and is conducted by persons who are technically qualified and fully experienced in the job of examining the books of account of various types of concerns It is not simply a mechanical comparison of accounting records with evidences or statement It also does not simply mean ticking of entries with related vouchers It, however, contemplates verification

1 Eric L Kohler, *Auditing*, p 10.
2. Mautz, R K, *Fundamentals of Auditing*, 2nd. ed p. 1
3 Robert E Schlosser, Field of Auditing, in *Handbook for Auditors* (Ed) J A Cashin, 1971, p 4.

of accounting records with certain pre-determined objectives, testing their reliability and competency, and finding out adequacy of evidences for those records It involves *critical assessment of whole affairs of a concern* It involves thorough examination, which is essentially retrospective and analytical The record which has to be examined is not prepared by the auditor *himself* It he does it, he acts as an accountant. Then, the audit is *carried on regularly or periodically* Generally it is done after the final accounts have already been prepared and thus it may be half-yearly or annually. Big concerns may even get it done throughout the year

The auditor has *to satisfy himself as to the truth and fairness* of the statement of financial affairs of the business He has to give his report honestly to the owner of the concern His integrity, honesty and independence are essential otherwise the very purpose of audit may be defeated He examines the books of accounts and checks their arithmetical accuracy He has also to ascertain the various policies as regards the operation and control of concern and how far they have been carried out by the management and to what extent the accounts reflect them He has *to form opinion* as to the ability of financial statements to convey clearly the meaning of what they purport to stand for

He should carry on audit *as thoroughly as possible* The extent of thoroughness would depend upon the individual circumstances of each case and he will have to exercise his own discretion for the same. One more point which has to be borne in mind is that auditing is *not confined only to the business organisations* as has been emphasised by various authors on the subject It may be necessitated by any economic unit and today there are numerous non-business organisations (e g educational institutions) which get the accounts audited by professional auditors

In brief the auditing involves the following *main elements* or *aspects*.

(*i*) It is a thorough, systematic and analytical examination of the accounting records of the client.

(*ii*) The accounts have to the prepared by other, and, not by auditor,

(*iii*) The auditing is to be carried on periodically by the inde-
person, with the help of relevant records,
ormation and explanation etc. following
accepted tools and techniques of auditing

(*iv*) The auditor has to satisfy himself and report with regard to the truth and fairness of the profit or loss of the period and financial position of the concern, as reflected in its Balance Sheet

We may, thus, define audit as a systematic examination of accounting records, prepared by others, of a business enterprise or other economic unit, ascertaining that they correctly reflect the related transactions to the satisfaction of a qualified auditor, who has to report honestly, giving his opinion as to the propriety of financial statements and accounts

ACCOUNTANCY AND AUDITING

Auditing is quite different from Book-keeping and Accountancy as auditing has no concern with the writing of books or the preparation of accounts. Book-keeping is an art of recording all the business transactions in the books of account and is mainly related to books of original entry as well as the Ledger This work is, in general, entrusted to junior employees under the direct supervision of accountants They generally do not possess any specialised training as the work is of a mechanical nature and in the advanced countries various machines are used for such jobs Accountancy is mainly concerned with the preparation of summaries and analysis of the record furnished by book-keeping Earlier, no differentiation was made between accountancy and book-keeping, but with the increase in size and complexity of business it became essential *Accountancy begins where book-keeping ends* and, as a matter of fact, the former includes the latter The preparation of accounts is generally kept in charge of some senior employees called accountants, who have advanced knowledge and training in the subject They have not only to prepare the final accounts comprising a Profit and Loss Account and a Balance Sheet but also undertake their interpretation They have to analyse them and draw conclusions which are helpful in framing and guiding the future policy of the concern

Auditing is quite distinct from Book-keeping and Accountancy as they differ in their respective objects and nature The distinguishing feature of Auditing is that it is analytical and essentially retrospective whereas Accountancy is primarily constructive and concerned with current recording of business facts The existing records are subjected to critical analysis for proving or disproving their accuracy Auditing *really begins where Accountancy ends* An auditor commences his work when all the accounts and statements have already been prepared. An accountant is primarily a constructionalist, an auditor primarily an analyst Auditing is mostly carried out by trained professional accountants organised to offer their services to the public They are capable of doing the work of accountancy as well as auditing and, therefore, are called accountants. For example, in India an auditor should be a Chartered Accountant, but such qualification is not necessary for an accountant responsible for the preparation of accounts of a concern Many businessmen are not clear in their minds and feel that if a professional accountant prepares the accounts, he guarantees their accuracy also. But an auditor cannot give a report as to the truth and fairness of a Balance Sheet unless the audit work

has been methodically conducted and all the transactions recorded in the books are compared, checked and verified Such difference was clearly recognised in *Apfel v Annan Dexter & Co* (1936), *Leach v Stokes and others* (1937), *and Commissioner of Income Tax, Madras v G M Dandekar* (1952)

Points of difference between Accountancy and Auditing·

1 Accountancy refers to preparation of final accounts and its interpretations which may be helpful to the management or the proprietor whereas the auditing refers to examination and checking of these accounting records

2 The object of accountancy is to find out the working results of a given period and show the financial position of the concern as on a particular date whereas the object of auditing is to find out the truth and fairness of the earnings and the financial position of the concern and also to prevent and detect the errors and frauds

3 An accountant need not be a chartered accountant whereas an auditor must be a chartered accountant

4 An accountant is an employee of the concern and works directly under the management whereas an auditor is not an employee but an independent person appointed by the proprietor with specific purpose

5. An accountant is a permanent employee of the concern, whereas an auditor is not and he may be changed from year to year

6 An accountant need not have thorough knowledge of auditing and its techniques whereas an auditor must have thorough knowledge of accountancy otherwise he cannot perform his job satisfactorily

7 Auditing begins where the accountancy ends.

8 Accounting work is undertaken throughout the year whereas the auditing is generaly carried on at the end of the financial year or periodically.

9 An accountant is not required to submit a report to the proprietor when the accounting work is over but an auditor must submit the report to the proprietor after the completion of his audit work.

ADVANTAGES OF AN AUDIT

The audit of the accounts of a concern has many advantages and in the case of a joint stock company it has been made compulsory by law The organisation of the business concerns today has become so complex that an individual or group of individuals cannot

look into every aspect of the concern Absentee-ownership is the essence of the joint stock companies The divorce between capital and management is a general feature of modern business organisation. It is only through the auditing of concerns that truth and fairness of financial statements of the concerns can be ascertained The old controversy that "accountancy is a necessity, while auditing is a luxury" is over now in the present set-up of the business world It may be true, however, in case of a few small and petty traders who do not require formal auditing to be carried on by the experts They cannot afford to be formal in maintenance of proper accounts and getting them audited It may also turn to be expensive for them However, the following chief advantages accrue from an audit .—

(i) It *ensures the correctness of the accounts* to a great extent The truth and fairness of the financial statements are certified which helps a lot to the proprietors, management or anybody who deals with a particular concern The reliability of the accounts and financial statements, thus, is increased

(ii) It *enables the detection and prevention of frauds and errors* and thus it serves not only as a corrective measure but exercises a great moral influence on the whole staff putting a check upon the dishonest employees

(iii) A regular audit *makes the clerks so alert and vigilant* that the books of account and all other records are kept up-to -date Thus, it prevents the application of wrong principles and methods in accountancy, as well as carelessness and irregularity on the part of the members of the staff

(iv) The audited accounts *enable the comparison of accounts from year to year* and thus the fluctuations, if any, may be accounted for Moreover, through such comparison and analysis the management possess the facts upon which they may reasonably base their decision for framing future policy for the benefit of the concern

(v) The audited accounts are *helpful in obtaining additional capital or borrowing money from the banks* or other sources Unaudited accounts may not be attended to to by the banks etc for purposes of security and verification of financial position of the borrowing concern

(vi) In case of loss by fire, *the compensation may be claimed from the insurance company* on the basis of the previous audited accounts The estimates for the claim must be scientific and based on reliable past records

(vii) It *helps in the valuation of the property or goodwill* of a concern, when, the business has to be sold out or a firm has to be converted into a joint stock company. It will be done arbitrarily if the accounts are not reliable

(*viii*) The audited accounts are taken to be *more reliable* by the tax authorities for purposes of tax-assessment.

(*ix*) The *third party*, who has dealings with a particular concern or is interested in its profit or its financial soundness, *would be helped a lot by the accounts* of the concern if they are audited and duly certified by an independent auditor. They may be sure of absence of any window-dressing in the presentation of final accounts

(*x*) In a partnership firm, the audited accounts are *more helpful in the settlement of accounts* between the partners amicably and thus avoiding any dispute amongst them It will be of great use at the time of division of profits amongst the partners, admission of a new partner, settlement of accounts in case of retirement of a partner or death of a partner, or for a sleeping or dormant partner

(*xi*) An auditor may be consulted by the management, whenever needed and he may *offer expert advice* to improve the accounting, financial as well as other set up of the concern although he may not be compelled to do so as it is not a part of his duties. But customarily, an auditor helps a great deal in bringing improvements in the organisation of a concern by his mature advice

(*xii*) It *instils confidence* in the minds of large number of investors and others in the various business organisations, specially in a joint stock company, simply by bringing all the facts to light and thus ensuring whether capital invested is safe or not

(*xiii*) Audited accounts are *more reliable as evidence* in the court of law

SPECIFIC ADVANTAGES OF AUDITING TO A PARTNERSHIP FIRM

Besides the general advantages available from auditing the books of accounts of a firm, following specific advantages are also available to it.

(*i*) The auditor is able to draw the attention of the partners for non-compliance of the provisions of either Partnership Act or the partnership deed

(*ii*) The audited accounts would help in the settlement of disputes between the partners easily and conveniently. It helps in preventing the disputes in future to a great extent

(*iii*) The audited accounts help in the settlement of accounts in the event of death or retirement or admission of a new partner. In practice, serious problems arise on these occasions and they can be easily solved if the accounts are duly audited by an independent auditor.

(iv) The audited accounts help the firm in negotiating with the banks or other financial institutions at the time when it wants to take loans from them

(v) The audit of accounts is greatly helpful to the sleeping partners who do not take any active interest in the working of the firm though the capital has been contributed by them substantially If the audit of accounts is carried on their behalf that would benefit other partners also considerably

(vi) The auditor helps in preparation and filing of the tax returns of the firm The provisions of the taxation laws are becoming so complicated year by year that advice and suggestions of the auditors in this respect would be quite helpful to the partners of the firm

(vii) The audit of accounts of the partnerships firms is not compulsory but the tax audit may be ordered under the Income-tax Act, 1961 under certain circumstances Under those circumstances, the audited accounts would greatly help the firms It may also be noted that if the accounts are regularly audited by an independent auditor, there may be no need for such tax audit This will help the Government also

Limitations of Audit Besides the numerous advantages of auditing mentioned above, it suffers from several limitations also Some of the chief limitations of auditing are as follows

(i) The audting *does not reveal the complete picture* as, while examining the books of accounts, an auditor has to depend upon the facts shown by the books In case, the facts have been wrongly manipulated in an ingenious way, the auditing may not reveal them.

(ii) Sometimes the entries in the books of accounts do not speak themselves and an auditor has to depend upon the explanations, clarifications and information from the client or some responsible persons whenever he is not clear on certain matters He may or *may not get the complete or correct information or full explanations* or necessary clarifications He may, then, have to submit his reports under such handicaps

(iii) In auditing, the opinions of the experts are sought on various occasions, as an auditor is not expected to be expert in all the areas For example, he cannot be supposed to have the knowledge of an engineer or an advocate Under such circumstances, he obtains certificates from various experts who may or may not give the correct certificates *An auditor has to rely upon them and if the certificate has been given wrongly the report submitted by him may not be correct.*

(iv) The auditing of books of accounts, in practice, *may not serve the real purpose* unless and until the auditors are quite inde-

pendent and bold enough They should also possess high moral standards Lack of these qualities may result in submission of a clean report even if there are certain discrepancies in the accounts

(*v*) The auditing *does not give any guarantee* as to correctness of the financial accounts of a concern whose books of accounts have been audited by a duly qualified auditor It is because preparation of financial statements often involves considerations of so many different factors, which require the exercise of judgment, often not susceptible to a precise determination Often detailed checking are not undertaken as that is not practicable.

(*vi*) Audit requires application of professional judgment in a tremendously wide variety of situations and circumstances An auditor broadly expresses his judgment of the fairness with which these statements present the state of affairs of a particular organisation. Thus, even the audited accounts may be incorrect sometimes

(*vii*) Auditing is more like a *post-mortem* examination It is often questioned as to what is the use of such examinations when events have already occurred It may be more useful for future but less helpful for the past

(*viii*) Often, the audit work is undertaken by auditor in a biased way and he is not able to remain independent, in practice, even though he wants to remain so.

Questions

1 Explain the major factors responsible for enlarging the scope of auditing today.

2 What do you understand by Auditing? Give suitable definition of Auditing

3. Define Auditing and explain its advantages

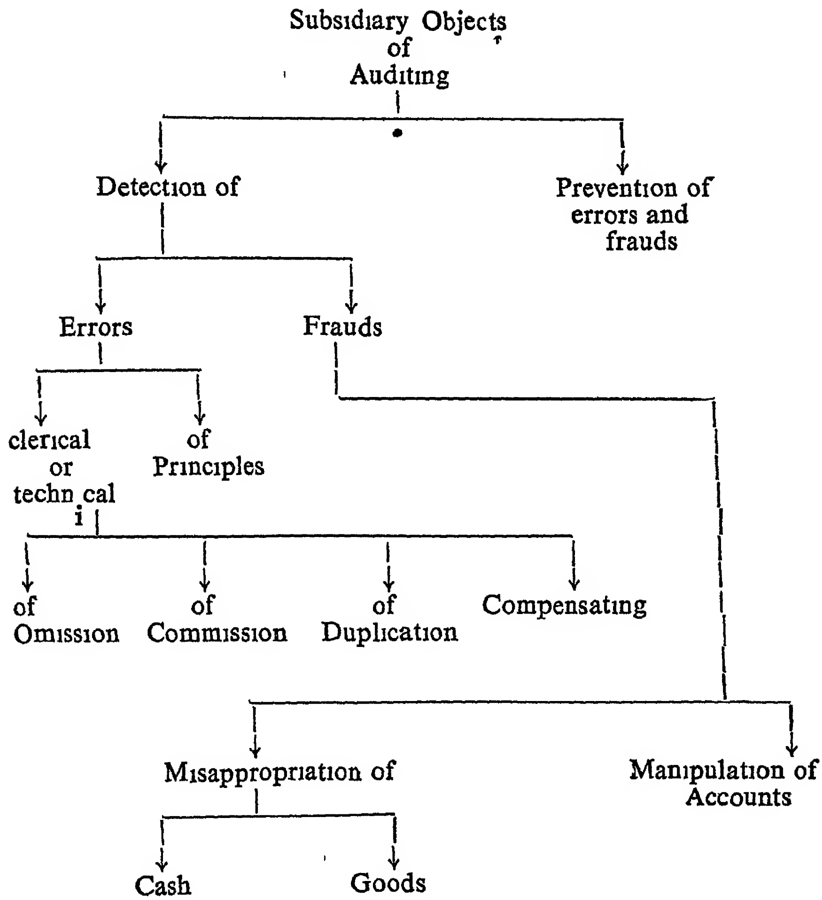
4. "Auditing, though useful, is not free from limitations" Explain it

5. "Accounting is a necessity while Auditing is a luxury." Explain this statement and discuss whether you agree with it.

6 Distinguish clearly between Book-keeping, Accountancy and Auditing

7. Explain the specific advantages of Auditing to a Partnership firm.

8. Discuss advantages and limitations of Auditing.



insurance premium has been paid for the whole year but the books show the payment for three quarters only and no entry appears in the books for the outstanding quarter The auditor may find it out by checking the receipt or making comparison with that of last year or by examining the accounts But it is not so easy to trace them in many intances Sometimes, such omissions are deliberately made by the employees with a view to commit some fraud or manipulate accounts These errors affect the accounts and profit or loss materially They may even affect the financial statement It requires great care to detect such omissions.

These errors, in general, do not affect the trial balance However, if there is partial omission it would affect the trial balance and may be traced out easily.

(*ii*) The *errors of commission* occur because of incorrect records made in the books of account They may consist of wrong entries, postings, castings, calculations and carry forwards For instance, the purchases worth Rs 5100 may be entered in the books for Rs 1500, or the rent paid to be posted to the debit side of the Cash Book may be posted to the credit side, or the same amount may be posted twice to the same account or posted by wrong amount or a wrong calculation of the amount may be made The agreement of the trial balance would depend upon the nature of the mistake committed by the staff If, for example, wrong calculations are made of the value of goods it would not affect the trial balance; but if balance of an account has been taken wrongly or casting or carrying forwards are made wrongly, they would affect the trial balance Such errors are common but it is comparatively simple to discover them by a cautious routine checking of books of account.

(*iii*) The *errors of duplication* are also clerical errors and occur if the same transaction has been recorded twice in the books of original entry and also posted twice in the Ledger For instance, purchases worth Rs 2,000 may be recorded twice in the accounts As these errors would not affect the agreement of the trial balance, it is not so easy to trace them But with a little care, it may be traced out by an auditor while checking the vouchers and other records.

(*iv*) *A compensating error* may arise when errors counteract each other If an error is committed amounting to Rs 500 on the debit side and, per chance, another error of the same amount is committed on the credit side, they would compensate each other. They may be dissimilar, in nature, but counteract each other by the same amount They would not affect the trial balance and thus may be difficult to be traced out by the auditor Such errors may have far-reaching consequences if they affect profit or loss of the business considerably.

B Errors of Principle They arise when the transactions are not recorded in the books of account according to the fundamental and accepted principles of Accountancy. These errors may consist of, for instance, wrong allocation of expenditure between revenue and capital or valuation of assets on a wrong basis, or making incorrect provisions for depreciation or bad and doubtful debts. These errors are important as they affect the profit or loss and the financial statement materially They may be deliberate also in that case it would be a matter of deep concern for the auditor He must always be on the look out for such errors Mere routine checking of the books of account may not help in detecting such errors and only intelligent, careful and thorough checking may disclose them The auditor has to be very careful about such types of errors

The detection of errors is an important part of an auditor's duties since it involves the accuracy of the accounts and the statements He has always to be very careful about these errors, parti-

cularly for those errors which might have been deliberately made by the trusted officers of the concern However, it is no part of an auditor's duty to trace and locate the difference in the books he is required to audit Whether he should pass the accounts even when the trial balance does not agree would depend upon the particular circumstances If the amount involved is huge and would affect the profit or loss materially, he must insist upon the books being balanced before he approved the accounts

(2) DETECTION OF FRAUDS

The detection of frauds by the auditor is also of considerable importance and is more difficult than the detection of errors He has to take pains to unearth it. While doing so, he should always avoid any hostility and mistrust towards the staff of the organisation and should always be polite and tactful At the same time, he should be bold enough to carry on thorough investigation the moment his suspicion is aroused [1] The fraud has to be checked in early stages, otherwise it is difficult to detect if it assumes complications It is now generally recognised by the accountants and by business management that even the detailed audit may not uncover certain types of fraud The discovery of fraud is no longer the principal object of the annual audit But it does not mean that the auditor should be negligent

Frauds connected with the accounts may take place either (1) by the misappropriation of cash or goods, or (2) by the falsification of accounts without any misappropriation

The *misappropriation of cash* may take place in two ways .—(*i*) by omission of receipts or acknowledging a lesser amount than actually received, and (*ii*) by inclusion of fictitious payments or recording more payments than actually made It is more difficult to detect the former than the latter. Some of the examples of misappropriation of cash are as follows

(*i*) Cash sales may not be recorded at all and money received on that account may be misappropriated

(*ii*) Record of credit sales may be omitted and money received from customers later may be pocketed

(*iii*) Method of "teeming and lading" may be adopted and money received from the customer may be pocketed and when received from the other customer that may be shown as received from the former customer This process may be continued for long and it may involve cash received from many customers

(*iv*) Cash received from sale by 'V.P.P.' or 'Sale or return' may be pocketed

(*v*) Payment or account of fictitious purchases or 'dummy'

1. In *re The Kingston Cotton Mill Co. Limited* (1896).

workers may be recorded and cash on those accounts may be pocketed

The chances of such frauds are remote in case of small concerns where the proprietor has got direct control over his employees But this is not possible in the case of a large concern where frauds may frequently occur if suitable checks are not imposed To detect the first the auditor should make a careful comparison of records in the Cash Book with other subsidiary books and the original vouchers. To detect the fictitious payments made, he should examine carefully all the original vouchers, invoices and wage-sheets etc and other available direct evidences

The chances of *misappropriation of goods* are greater in case of goods which are less bulky but more valuable Its detection is not easy Much will depend upon proper arrangement of issue of items from stock and the accuracy of stock records The periodical comparison of percentage of gross profit to sales may give a clue but may not help much A continuous vigilance has to be maintained over the issue of materials, records of sales, purchases and stock The more efficiently the stock is maintained and periodically checked, lesser the chances of misappropriation of goods

The *falsification of accounts*, without any actual misappropriation of cash or goods, involves greater intricacy and is more difficult to discover It is undertaken to conceal the true position of the concern It is generally perpetrated by the managers, directors or other responsible officials The object of such manipulation may be to bolster up the profits of the concern with a view to securing larger amount of commission due to themselves, or with a view to showing their success in management by paying more dividends, or to disposing of their shares in the concern at high profits, or to obtain more credit or more capital for the concern, or to avoid taxes by showing lesser profits Such manipulation may be carried on in many ways, some of the *methods of manipulating the accounts* are as follows.

(*i*) Recording fictitious sales or purchases

(*ii*) Recording or omitting to record various expenses

(*iii*) Charging revenue expenses as capital expenses or *vice-versa*

(*iv*) Overvaluation or undervaluation of the stock, or other assets or liabilities.

(*v*) Charging more or lesser amount of depreciation or provisions.

(*vi*) Creation or utilisation of secret reserves

(*vii*) Window-dressing.

Sometimes such manipulation may take the form of '*window-dressing*' also. It implies the presentation of Balance Sheet showing the affairs of business more favourable than what they actually are

It may be the result of some financial policy adopted during the last few weeks of a trading period But it need not necessarily be fraudulent or wrong If some special efforts are made to collect money from the debtors to show better position of the concern, it would not involve an illegitimate window-dressing But such instances are not usual and in general their legitimacy may be questioned

(3) PREVENTION OF ERRORS AND FRAUDS

Besides the detection of various types of errors and frauds, an auditor has also to prevent them Primarily, prevention of errors and frauds is possible only by application of sound system of internal check and suitable management of the concern An auditor simply puts a moral check upon the staff by detecting them. Such moral check is imposed on the employees of the client automatically since they would be always alert and would not carry on any dishonest transactions as they will be afraid of their detection by the auditor sooner or later He should make a detailed study, analysis and evaluation of the internal control system of the enterprise and find out its weaknesses He should, accordingly, offer his suggestions for making improvements in the management and internal control of the concern so that there may be minimum opportunity for errors and frauds to occur After all, 'prevention is better than cure' and accordingly efforts must be made to ensure it It has been found in practice that ingeniously laid down frauds have defied any detection Therefore, they should be prevented at the outset An auditor may help to attain such objectives by a careful and detailed checking, wherever necessary, so as to unearth the errors and frauds, if any He would, thus, assist the management in setting right or dispensing with the dishonest employees This will, in itself, have sobering effects on the employees to remain honest and careful

VARIOUS CLASSES OF AUDIT

We find that, in practice, various classes of audit are undertaken It may be classified from many points of views From the point of coverage, it may be complete or partial A *Complete audit* is one in which all the transactions recorded in the books of accounts are audited thoroughly A *Partial audit* is one in which only particular type of transactions is audited

From the point of legality, it may be voluntary or compulsory. A *Voluntary audit* is one which is carried on at the sweet will of the proprietor of the concern He may or may not get his accounts audited Whereas, the *compulsory audit* is one which has been made compulsory under specific statute and the proprietors of the concern must get their accounts audited compulsorily For instance, it is compulsory for all the companies to get their accounts duly audited under the Indian Companies Act, 1956

From the point of nature of organisation, it may be private or Government audit *Private audit* is one which is undertaken by the private organisations, such as, sole traders, partnership firms or joint stock companies *Government audit* is applicable to the Government departments and departmental undertakings. It is undertaken in a different way

From practical point of view, it may be broadly classified as *Final*, *Continuous*, and *Interim* audit They have been explained, in detail, below.

From the point of specific objectives, the audit may be *Cash audit*, *Special audit*, *Cost audit*, *Joint audit*, *Systems audit*, or *Proprietary audit.* They have also been explained in detail later.

From the point of degree of independence, we may classify audit in two classes, such as, *Independent* or *Statutory audit* and *Internal audit* Independent audit or Statutory audit refers to the audit undertaken in case of various business or other organisations independentally by duly qualified auditors, mainly in accordance with the statutory provisions under certain Acts. Whereas, the Internal audit is undertaken by the employee of the concern, specially large one in size The internal audit is neither compulsory nor undertaken by the duly qualified auditor under certain statutory provisions.

CLASSIFICATION OF AUDIT

1.	*From the point of coverage*	(*a*) Complete (*b*) Partial
2.	*From the point of legality*	(*a*) Voluntary (*b*) Compulsory
3.	*From the point of nature of organisation*	(*a*) Private (*b*) Government
4	*From practical point of view*	(*a*) Final (*b*) Continuous (*c*) Interim
5.	*From the point of specific objective*	(*a*) Cash audit (*b*) Special audit (*c*) Cost audit (*d*) Joint audit (*e*) System audit (*f*) Proprietory audit
6.	*From the point of degree of Independence*	(*a*) Independent or Statutory audit (*b*) Internal audit

DISTINCTION BETWEEN CONTINUOUS AND INTERIM AUDIT

Often there is a confusion between the continuous and interim audit To make it clear, the following points of difference between the two may be understood clearly

1. The object of continuous audit is not to find out the profit or loss of the concern for a given period whereas in case of interim audit it is undertaken with a specific object of finding and checking the profit or loss for a given period

2 Under the continuous audit, the accounting records of one accounting or financial year is examined thoroughly, whereas in case of interim audit, accounting records upto a certain date only are checked.

3 In case of continuous audit, the trial balance is not prepared at intervals, whereas in case of interim audit the trial balance must be prepared and checked at the time of such audit.

4. In case of continuous audit, the verification of assets and liabilities is undertaken at the close of the financial period, whereas in case of interim audit, it is undertaken at the time of such audit

5 The auditor's report is submitted at the end of financial year in case of continuous audit, but this is not so in case of interim audit In the latter case, it is submitted at the time of audit

Cash Audit The cash audit is undertaken with a limited purpose of examining the cash receipts and payments It does not involve thorough checking of all the records Often, it may involve even the preparation of Cash Book. The auditor has to be very careful in auditing Cash Book as it may contain manipulations He must refer to all the relevant vouchers and documents to satisfy himself that all the cash receipts and payments have been duly recorded While reporting he should mention that he undertook only cash audit.

Besides the general audit, there are two other kinds of audit related to the joint stock companies in India They are Special Audit and Cost Audit We mention them below in detail

Special Audit. The Companies (Amendment) Act, 1960 has empowered the Central Government to order special audit of the companies in certain cases Under section 233A it can direct special audit of company accounts when it is of the opinion

(a) that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial policies, or

(*b*) that any company is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains, or

(*c*) that the financial position of any company is such as to endanger its solvency

It would, thus appear that the case for special audit arises because of inefficient management or financial position of the company It is quite necessary in the interest of the growth of trade or industry so that the national interest may not be subservient to the interest of a few individuals

The Central Government may pass an order for conducting special audit of the accounts of any company for such period or periods as may be specified in the order It may, by the same or a different order, appoint either a chartered accountant or the company's auditor himself to conduct such special audit The auditor, so appointed, is known as special auditor and his powers and duties are provided under section 227

The special auditor has to submit a report which will not be addressed to the members of the company, as is done in the case of regular audit, but if will be addressed and submitted to the Central Government On receipt of his report, the Government may direct such action as it considers necessary in accordance with the provisions of the Companies (Amendment) Act, 1960 oi any other law for the time being in force If the Government does not take any action on the report within four months from the date of its receipt, a copy of the report of relevant extracts from it with comments thereon will be sent to the company by the Government It may require the company either to circulate the report (or its extracts) to the members or to have it (them) read at its next general meeting

The expenses of, and incidental to, any special audit including the remuneration of the special auditor shall be determined by the Central Government and are final All such expenses shall be paid by the company and in default of such payment shall be recoverable from the company as an arrear of land revenue

Cost Audit[1] The cost audit implies thorough examination of cost accounting records of a company It has been defined[2] as "the verification of the correctness of cost accounts and of the adherence of the cost accounting plan" It not only involves the examination of cost accounts but also the fact that the plan prepared in this connection has been duly executed

1 For details see chapter 31
2. Walter W Bigg, *Cost Accounts* seventh edition, p 319

would include "such particulars relating to utilisation of materials or labour as may be prescribed, if such company is required by the Central Government to include such particulars in the books of account " The Government may also direct that the audit of cost accounts of a company shall be conducted in such a manner as to obtain a true and fair view of the state of affairs of the company

The mode of appointment of cost auditor has been given in the next chapter His duties and powers are the same as prescribed in the case of auditor in general under section 227 (1) of the Act He will not submit his report to the members of the company but will have to submit it to the Company Law Board in such form and within such time as may be prescribed and shall also, at the same time, forward a copy of the report to the company.

Besides the above classification of auditing, let us discuss some more concepts of auditing, as they have developed recently They are Joint audit, Propriety audit, Performance audit, the Systems audit

JOINT AUDIT

An audit is said to be a joint audit when two or more persons or firms of Chartered Accountants are jointly appointed to conduct the audit of a company The practice of appointing joint auditors has been adopted by large-sized companies, specially the Government Companies, which want the pooling of the resources of two or more auditors so that the audit work may be undertaken effectively, expeditiously and quickly Most of the large-sized companies today do not appoint single auditor but the joint auditors So far as the professional work is concerned, these joint auditors stand on equal footing It may be pointed out that the Companies Act, 1956 is silent on this question It has not yet recognised this development statutorily

Joint audit may pose certain problems also There may be some difficulty in division of work and coordination There may also be difference of opinion between auditors However, these problems can be solved by natural discussion, consultation and agreement.

So far as the *liability* of the joint auditors is concerned, the joint auditors has an individual responsibility only Section 227 of the Act does not eontemplate any division of work of audit between two or more persons, therefore, there is no question of joint liability according to the Act It would not be quite proper also to hold an auditor responsible for the work not done by him but by another auditor If there are two auditors and both of them are held responsible jointly, that would create many practical problems.

While the Companies Act, 1956 is silent on this issue, the Institute of Chartered Accountants of India has issued a *Statement*

on the Responsibility of Joint Auditors It has been made clear in it that it would not be correct to hold an auditor responsible for the specifically allotted work of another Each joint auditor will be responsible only for the work allotted to him In case the work can be easily and clearly divided on the basis of identifiable operating units or specified areas of work, the responsibility to perform the work assigned to one of the joint auditors with reasonable care and skill will be his alone It is because the extent of work to be carried out is a matter of professional judgment and it may differ from auditor to auditor as no two firms or individuals will exercise this judgment in an identical manner Thus, according to it, we cannot hold auditor responsible for the work done by another auditor who is equally qualified and competent to undertake the audit work This also makes it clear that where the work cannot be clearly divided, the responsibility will be joint between them

PROPRIETY AUDIT

The concept of propriety audit is quite new in the history of auditing The propriety audit was contemplated specially in case of Government audit long back, yet it has been adopted there also only very recently Prof W A Robson had made a strong plea for the adoption of efficiency-cum-propriety audit as back as in 1937 in his book *Public Enterprise* He had advocated for the appointment of Efficiency Audit Commission for the purpose of carrying on detailed checking specially for the nationalised industries of U K In July 1967 again, he made a strong case for such audit for the nationalised industries Thus, it is only very recently that the efforts are being made in this direction. In our country, we have yet to evolve such audit in its fulness.

A suitable definition of propriety audit has yet to emerge The meaning of the term 'propriety' itself is not very clear to many and it is interpreted in various ways According to Eric L Kohler, their term 'propriety' may be defined as "that which meets the tests of public interest, commonly accepted customs and standards of conduct[1] Thus, according to it the propriety audit implies verification of accounting records in such a way as to find out whether the actions and decisions have been taken in the "public interest" and in accordance with the "commonly accepted customs and standards of conduct" It implies that mere comparison of accounting records with the related evidences is not enough and the auditor would have to take pains to see whether the transaction was "justified" or not. According to Kamal Gupta, "Propriety audit refers to an audit in which the various actions and decisions are examined to find out whether they are in public interest and whether they meet the standards of conduct."[2] Thus, the propriety audit is the "one undertaken for verifying that there has not been any leakage of revenue, misap-

1. *A Dictionary for Accounts*, 1970, p. 349.
2 *Contemporary Auditing*, 1977, p. 334.

propriety of assets, or wastage of funds, due to a transaction or a group of transactions having been entered into either inadvertently or deliberately in disregard of any legal requirement or an economic or financial consideration" It is a special investigation carried out for ascertaining that contracts, except relating to routine transactions entered into with third parties, are in the best interest of the concern and that there is a system which ensures adequately the safety of the assets of the concern"

The propriety audit has to be distinguished from the *performance audit* The performance audit is another function of audit and differ from the propriety audit although both are the twin aspects of the management audit. The performance audit is a procedure for "(i) analysing the profits and losses of different economic activities in which the concern is engaged, (ii) determining the relationship between production and sales, (iii) determining whether the sales pattern has deviated from the one considered ideal, (iv) for maximising profits, and (v) determining the imbalance, if any, in the inventory"

As pointed out earlier, the propriety audit has been undertaken in some way or the other in the various Government department It has been the prime concern of the Comptroller and Auditor-General of India In audit of private companies, the auditor has been mainly concerned with reporting of his opinion as to the truth and fairness of the financial state of affairs and the earnings of the company In general, the auditor does not worry for the propriety audit However, it is not so in case of the Government audit, where its importance has been duly recognised, though not enforced with sincerity According to Asok Chanda, earlier the Comptroller and Auditor-General of India, "Audit is not an inquisition and its mission is not one of fault finding Its purpose is to bring to the notice of the administration lacunae in the rules and regulations, and to suggest, wherever possible, ways and means for the execution of plans and projects with greater expedition, efficiency and economy [1] This brings in its ambit the idea of propriety audit It implies that mere testing the accuracy of accounting and estimating is not enough but it was more important that the expenses should be incurred wisely and economically and extravagance and wastes are duly avoided At another place, he has pointed out that his functions are not merely to ensure that the expenditure conforms to rules, but also to satisfy himself as to its 'wisdom, faithfulness and economy' The audit has to be directed towards discovering waste and matters beyond accounting, which, though *intra vires*, are apparently unwise or extravagant [2] In *An Introduction to Indian Government Accounts & Audit*, published by the Government of India certain principles have been mentioned which have long been recognised as standards of financial propriety and the auditor has to see that those general principles have been duly adhered to

1. *Aspects of Audit Control*, 1960, p. 26.
2 *Indian Administration*, 1958, p. 247.

While explaining propriety auditing, Laxmi Narain[1] points out that "it extends beyond the formality of expenditure to its wisdom, faithfulness and economy The general principle applied there is that every public officer should exercise the same vigilance in respect of expenditure incurred from public money on a person of ordinary prudence would exercise in respect of expenditure of his own money The audit investigates the necessity for the expenditure incurred and asks whether individual items are in furtherance of the scheme for which the budget provided, whether the same results could have been obtained otherwise with greater economy and whether the rate and scale of expenditure were justified in the circumstances " In fact, the audit claims to ask here every question that an intelligent taxpayer bent on getting the best value for his money could ask Thus, it involves enquiry against the propriety expenses and not merely that expenses have been incurred and vouchers are present

In general, in case of audit of a company (in private sector) the duty of an auditor does not extend to the area of propriety audit Section 227 of the Companies Act, 1956 also does not contemplate it However, the duties of an auditor, as provided under the above section, can be extended by the shareholders, though they cannot be curtailed Thus, the shareholders of a company may desire to extend the duties of an auditor so as to include the pro- priety audit of the accounts.

Recently, certain amendments have been made in the companies Act in such a way as to include propriety audit of certain transactions entered into by a company By the Companies (Amendment) Act, 1965, sub-section (1A) was added to Section 227 of the Act In consequence, it has become obligatory for an auditor to enquire into the propriety aspects of certain types of transactions entered into by a company In case his enquiries show that some of the transactions entered into by the company are not in the best interest of the shareholders, it is his duty to report the fact to them The additional reporting requirements prescribed under Section 227 (4A) of the Companies Act also contain the matters when propriety aspects require due consideration on the part of an auditor

Section 227 (1A) requires a company auditor to enquire whether or not the loans and advances made by the company on certain terms are not prejudicial to the interest of the company or its members It also requires an auditor to enquire whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company or whether the personal expenses have been charged to revenue account Thus, it has extended the duty of an auditor to look into the propriety aspects also while auditing the accounts of a company

Similarly, under section 227 (4A), the Central Government has extended the duty of a company auditor to look into some pro-

1. Laxmi Narain *Efficiency Audit of Public Enterprises*, 1972, p 2.

priety aspects of certain transactions and the Government accordingly may direct that the auditor's report shall also include a statement on such matters as may be specified therein

Provisions of Section 233 (B) of the Companies Act, 1956 related to the Cost Audit also require the auditor to include in his report certain aspects related to the propriety of the transactions Section 619 (3) of the Act which deals with the audit of Government Companies also provides for propriety audit of such companies on several vital issues

SYSTEMS AUDIT

With the enormous growth in the size af business enterprises, the traditional audit is giving way to a new technique of auditing known as Systems Audit This technique has been developed very recently in Canada and U S A and is gaining considerable popularity as an aid to the Balance Sheet auditing Along with the growth in size, there has been very rapid growth of automation, use of computers and other sophisticated techniques to maintain records, and substantial improvement in the designs of internal control which have necessitated the use of this modern technique of auditing In fact, these developments have relieved the auditor from various onerous work of verification of evidences and other records thoroughly

Thus, the systems audit is a detailed enquiry about the various systems of accounting and controls prevailing in the enterprises and find out whether they are working efficiently or not with a view to formulate the opinion about the financial statements According to Skinner and Anderson the systems audit is an attempt "to explore inside the system and discover exactly how it produces results If the mechanics of the system were analysed intensively and the detailed survey showed it to be designed with appropriate controls, checks and balances to forestall errors, then this would be a good indication that the results produces by the system were accurate " They further point out that with this background the auditor attempts to "make inferences about the whole of the accounting results from a knowledge of the detailed system which produced them "[1]

A systems audit, which may also by termed as *analytical auditing*, however, does not totally replace the independent balance sheet auditing. In fact, it is an aid to the latter, as it helps the auditor in finding out whether the control systems are effective and reliable or not This saves the time, botheration and cost of the independent auditing We know that in traditional auditing efforts are made to make a thorough checking of the accounting records with the related evidences But if the systems audit suggests that the control systems, as operative in the enterprise, are quite effective and reliable, he need

1 Skinner, R M and Anderson R.T., An Outline of Flow Chart Approach to Audits, 1966

not check the data in the above fashion. He can, then, fairly rely upon the accounting data and devote more time in formulating his opinion as to the truth and fairness of the financial statements

The techniques adopted for the purpose of systems audit are also of recent origin and is highly technical It requires full technical knowledge of the enterprise and various systems which may be adopted Mere knowledge of methods of keeping accounts would not do The auditor would have to be conversant with the various systems and their analysis In fact, the technique of flow charting and the procedural tests are very much helpful in finding out the effectiveness and reliability of the systems

The following *steps* may be taken for the purpose of systems audit ; (*a*) review the systems thoroughly , (*b*) test the systems with some representative samples and see their effectiveness , (*c*) prepare the flow charts thoroughly and analyse the same , (*d*) with thorough examination, find out the weaknesses and strength of the system , (*e*) plan the audit on the basis of degree of reliability of the systems , (*f*) make a detailed verificatory checks of transactions wherever the weaknesses exist in the system , (*g*) suggest for the improvement of the systems, if necessary

The systems audit is of very limited use in a country like India where most of the enterprises do not have a well-designed system and the mechanised accounting specially use of computer, is not used in practice A systems audit presupposes a well-designed system and, in their absence, there is no question of adopting this technique of auditing It will become more popular with the adoption of automation and latest techniques of data recording and processing

INTERNAL AUDIT

Internal audit is a continuous and systemic process of examining and reporting the operations and records of a concern by its employees selected specially for this purpose It is, in essence, auditing for the management and its scope may vary, depending upon the nature and size of the concern

Its development is directly attributable to the needs of management resulting from the growth of large-scale bussiness undertakings Due to large size of the concerns it became impossible to depend extensively upon outside or independent auditing services Final audit alone does not help much whereas the continuous audit, which is desirable for big concerns, is very expensive Hence, *the increases in the costs of independent auditing, time-lag between the transaction and its audit, the growing need for more than one annual checking and provision of a more potential tool of internal control, all necessitated the growing use of audit activity by employees within the business unit* Now it is being increasingly realised that internal auditing is one of the functions of management. Many concerns employ internal check to perform much of these jobs for this purpose but some actual

auditing is necessary to control internal check itself and ensure its effective application.

The internal auditor has now assumed several important *functions* beside his basic function of assisting management Being an employee of the concern, he is more familiar with its policies and procedures etc He ensures the effective application of established policies, rules, procedure, and internal check He has to make constant review of internal control procedure and suggest necessary changes for the same He should see that the obsolute procedures are scrapped, loopholes are plugged and prompt corrective measures have been taken, wherever necessary His presence encourages accurate and careful work by the other employees of the concern He is of great assistance to the independent auditor in final auditing He may be called upon by the management to make various special checkings or investigations of the business He makes constant efforts to find out weaknesses and defects in the procedures and methods followed and in the organisation of the concern and suggests improvements He has to see that the procedures and policies laid down by the management are carried out properly He is expected to keep a watch over the income and expenditure of the concern and should conserve its resources as far as possible Besides, he has to verify the accounts He has to examine all the records made in the account books to ensure that they are accurate and reliable *Thus, an internal auditor performs the functions relating to evaluation, compliance, conservation, verification and a host of other activities*

Difference between Inernal Auditing and Independent or Statutory Auditing There is not much difference in the methods and procedures employed in both the cases, but they differ in various other ways as follows

(*i*) The main objective in case of internal audit is to fulfil the needs of the management whereas in independent audit the objective is to fulfil the needs of proprietors as well as third parties for reliable financial data

(*ii*) The internal audit may be carried out by a firm of practising accountants or by own staff but statutory audit can be entrusted in India only to a Chartered Accountant or a firm of Chartered Accountants, engaged in public practice, or to a Restricted State Auditor

(*iii*) The internal auditor's approach is to ensure that accounting system is efficient, so that the accounting information presented to the management throughout the period is accurate and discloses all the information that the management desires or requires The approach of statutory auditor is, however, governed by his duty to satisfy himself that the accounts to be presented to the shareholders exhibit is true and fair view of the profit or loss and of the concern's financial state of affairs

(*iv*) The remuneration of internal auditor is fixed by management, while that of independent auditor by shareholders

(*v*) The internal auditor is dependent on the management but the independent auditor is independent of the management, both in fact and in mental attitude

(*vi*) The duties of an internal auditor may be reduced as desired by the management but it cannot be done in case of independent auditor

(*vii*) Internal audit is carried on continuously throughout the year but independent audit is carried on periodically and usually once in a year

(*viii*) In internal audit the examination work is quite detailed but in case of independent audit the testing techniques on the basis of random samples are utilised to a large extent

(*ix*) An independent audit has to submit a report to the shareholders after the audit work is over, but as internal auditor is not required to do so The report, if any, has to be submitted to the management

(*x*) The services of an internal auditor can be easily terminated by the management but in case of an independent auditor only shareholders can remove him

Degree of reliance of statutory auditor upon internal audit The internal audit is of great help to the statutory auditor but it is not substitute for the final audit The extent to which the statutory auditor should depend upon it would differ from case to case The degree of such reliance on internal audit, however, is a question of discretion which the statutory auditor, looking into his statutory responsibilities, must exercise carefully, as he cannot plead that he had relied upon the work done by the internal auditor The statutory auditor cannot, in any circumstances, divest himself of the responsibilities laid on him by the statute In case, the statutory auditor curtails the extnet of his checking, putting reliance on the work of internal auditor, the responsibility for any deficiency in the financial statements, that may remain undetected, will be that of statutory auditor

Before, he arrives at any conclusion regarding the degree of reliance to be placed upon the internal audit, he should probe into the following facts thoroughly

(a) He should ascertain the efficiency of the internal audit In order to assess its efficiencey, he should examine the audit programme, working papers and reports etc thoroughly He should also make a test check of the work done by the internal auditor

(b) He should find out the experience and qualifications of the internal auditor and his staff He should also examine the

character of his reports to the management and the action taken by the management on the same

(c) He should find out the authority vested in the internal auditor and the level of management to which he is directly responsible

(d) He should see whether the internal Audit Department does only internal audit of the transactions or perform some other jobs also He should ascertain the degree to which the Internal Audit Department is independent of Operating Departments Its dependence on other Departments would very much reduce its value to the statutory auditor

Thus, examining the usefulness of the work done by the internal auditor, from his own point of view, the statutory auditor should apply his own discretion regarding the degree to which he may depend upon the internal audit

NEW PROVISIONS

The importance of the internal audit has increased tremendously with the passing of Manufacturing and Other Companies (Auditors' Report) Order, 1975 It came into effect from January 1, 1976 and requires that the Auditors' report shall include a statement in relation to companies, the paid up capital of which at the financial year concerned exceeds Rs 25 lakhs, whether the company has an internal audit system, commensurate with the size and nature of its business Thus, *for such companies, the internal audit has been made compulsory*

The Order has covered about 5,686 companies of the country It may be noted that India has the third largest membership of internal auditors with about 908 members already enrolled The U S A. and U K rank first and second with membership of 15,000 and 8 000 respectively This Order has provided a statutory status to the internal audit in the country

QUESTIONS

1 What are the objects of audit? Explain them fully.

2 "Detection and prevention of errors and frauds are the main objects of auditing" Discuss it fully and explain the duties of auditor in this regard

3 Write an essay on the "Objects of Auditing"

4 What are the various classes of audit? Explain them briefly

5 What is a final audit? Explain it and discuss its advantages and limitations.

6. Explain briefly the relative merits and demerits of the continuous and final audit

7 What is a continuous audit To which organisations it is specifically suitable? Explain its advantages and limitations

8 Discuss merits and demerits of the continuous audit What precautions should be taken by the auditor to safeguard against its dangers or shortcomings?

9 What is an interim audit? How does it differ from the continuous audit?

10 Explain with suitable illustrations, the various kinds of errors and frauds What is the duty of an auditor in this connection?

11 What is internal audit? How does it differ from the statutory audit?

12 Explain briefly the concept of propriety audit

13 What is internal audit? To what extent the statutory auditor should rely upon the internal audit?

14 Write short notes on.

(a) Cash audit,

(b) Special audit,

(c) Systems audit,

(d) Joint audit, and

(e) Cost audit

3

The Auditor

A person who is qualified as Chartered Accountant alone can practice as an auditor in India No such qualification is required for an accountant who is responsible for the maintenance of accounts in a business concern but he cannot conduct auditing of the books of account An auditor is also called a professional accountant and he may be entrusted with the maintenance of accounts only, but in that case he does not act as auditor Thus, an auditor can act as an accountant, but the latter cannot act as an auditor This distinction between an accountant or auditor carrying on the accountant's job and the auditor must be clearly understood

Qualities required of an Auditor An auditor must possess certain professional and personal qualities which help in performing his duties efficiently and honestly Some of these chief qualities have been discussed below

Professional Qualities (*i*) The auditor must be an expert in accounts and their interpretation He must possess thorough knowledge of all the systems of Accountancy in use and be able to read the various scripts in which the accounts may be kept, *e g*, English, Hindi, Muria, or Marwari. He is supposed not only to know how to record facts in accounts, but also to understand the significance of the facts in their relation to the past, present and future of the business He acts both as a reporter and an analyst which means that he must be capable of preparing those accounts himself He has to deal with the various systems of Accountancy in different business and must be capable of understanding their methods of preparation

(*ii*) He must have considerable knowledge about the organisation and operational methods of various types of business concerns He should be able to grasp various technical details as far as possible However, he is not expected to have as intimate knowledge of business as the client whom he serves

(*iii*) He must be master of various techniques of auditing Mere knowledge of accountancy, though essential, would not help him as the art of auditing is quite different from accountancy He must not think that if the trial balance agrees and the Balance Sheet agrees, everything else is all right He must understand that mere agreement of trial balance may show only arithmetical accuracy.

His duty is not to check arithmetical accuracy alone[1] At the same time he must avoid thinking and talking as a book-keeper He must overcome the limitations imposed by the restricted viewpoints of the book-keeper He must keep himself in touch with the advancements in the techniques of auditing

(*iv*) He must be familiar with the principles and practice of various business laws that may affect his profession He is not expected to have sufficient legal training, but he must possess thorough knowledge of various common and statutory laws relating to contracts, sales, agency, negotiable instruments, partnership, company or bankruptcy etc He must also have knowledge of economic and financial matters.

Personal Qualities (*i*) An auditor must be a man of integrity and must possess moral courage He must be a man of affairs capable of solving intricate problems patiently His duty is not to his client alone but to the public and other parties also He must carry on his duties faithfully without being led or influenced by others In the course of audit, he may find himself in a position when his own interests clash with those of his client In such circumstances, he must act tactfully and honestly without thinking of his own loss He must try to be absolutely impartial, unbiased and independent in making decisions regarding the client's affairs, which may or may not be in accordance with his wishes

(*ii*) He must never adopt an attitude of suspicion nor should he go about his work with an air of superiority or conceit.[2] He should not be hasty to criticise and should give full weight to assertions and opinions of the client's staff He must try to develop a spirit of mutual trust and goodwill between himself and the members of his client's staff. He should instruct his own staff to create a cordial atmosphere. However, friendliness should not be carried to the point of familiarity as it might involve loss of independence.

(*iii*) He must work honestly He must not issue a report containing statements which he has reason to believe to be untrue or misleading Lord Justice Lindley said "An auditor must be honest—that is, he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes that what he certifies is true"[3]

(*iv*) He must understand that the nature of his work is confidential He must not, therefore, divulge to others what he has learnt

1. *Deputy Secretary to the Government of India, Ministry of Finance v S N Das Gupta* (1955)

2 In *re Kingston Cotton Mills* (1896), Lord Justice Lopes Said "An auditor is not bound to be a detective or, as was said to approach his work with suspicion, or with the foregone conclusion that there is something wrong"

3 In *re London and General Bank*, 1895

about his client during the course of auditing[1] He will commit breach of moral duty if he does so

(*v*) He must exercise constant care, firmness and patience and should never do his work mechanically[2] He must possess an inquiring mind He should never display false pride of being an expert just because his ignorance may be exposed He should always seek clarity and elucidation on technical matters which he does not follow by discussions with those who know them He must not pass any transaction unless he finds it to be true and is satisfied that it is in order

(*vi*) He must be sincere in his profession He must follow the professional ethics, customs and regulations properly He should do nothing which may turn out to be a blot on his profession He should keep the professional standards in his mind and must follow them

(*vii*) He must be practical in his approach while giving advice to his clients as and when desired by the latter He must appreciate the practical needs and circumstances of the business He should give such advice as may fit in the particular situation. While doing so he may ignore such concepts which may be theoretically correct but may not be suitable in the particular circumstances It is to be noted that it is not a part of his duty to give advice but if his advice is sought he should willingly give it without insisting that it must be implemented

(*viii*) He must possess sound common sense "The auditor should have a full share of that most valuable commodity—common sense "[3] A thorough training in all the branches of theory may be of little use to him when he will be called upon to apply his common sense Thus, he must have ability to discriminate between the essentials and non-essentials

Importance of Auditor being Independent The books of account should be audited by an independent person who is duly qualified Unless the auditor is independent of the management or his client, his opinion is no more acceptable than the statements or accounts prepared by the management That is why his report becomes the charter of business confidence and his findings are held in high esteem Since the auditor is not an employee of the business, this situation alone creates considerable independence, but the fact that independence is also an attitude of mind is to be duly noted Independent thought and action are as important as independent

1 Chartered Accountants Act, 1949, Second Schedule, Part I (1).

2 In *re The City Equitable Fire Insurance Co Ltd*, 1924, Justice Romer said, "If an auditor has, even in one instance, fallen short of the strict duty of an auditor, he cannot, I apprehend, be excused merely because in general he has displayed the highest degree of care and skill "

3 Spicer and Pegler, *Practical Auditing*, p 32

relationship between the auditor and his client.[1] The reports submitted by the auditor may continue to have some value to all interested only so long as he enjoys the reputation of being independent It is his impartiality which has been the cornerstone of the trust placed in the findings of an auditor, but he can remain unbiassed or impartial only when he is independent to act Complete independence, however, may not be possible His difficulty in being independent arises because of the fact that he has to serve two masters He must please his client as well as all others who are interested in the client's business or financial statements Concern about the third parties should also be in his mind, even though he may not be legally bound to do so

He will have to act very carefully in such circumstances. Much tact and prudence will be required of him There is always a natural desire to please a client, but moving too far in this direction might result in giving a report which might eventually be misleading The degree to which he has to maintain his independence would depend upon the scope of work assigned to him If loss of independence to a certain extent does not come in the way of his duties, legal as well as contractual, he may remain dependent to that extent However, the auditor must try to remain dependent as far as desirable for fulfilling his duties otherwise the very purpose of his appointment will be jeopardised It is necessary specially in case of a joint stock company where the management may put some pressure on him in self-interest But he must not lose sight of the fact that he has to serve his real master, *i e* the shareholders

Hussein A Sharaf and R K Mautz[2] have suggested the following guides under each of the dimensions or components of independence of an auditor

Programming Independence

1 Freedom from managerial interference or friction intended to eliminate, specify, or modify any portion of the audit
2. Freedom from interference with or an uncooperative attitude respecting the application of selected procedures
3. Freedom from any outside attempts to subject the audit work to review other than that provided for in the audit process.

Investigating Independence

1. Direct and free access to all company books, records, officers and employees, and other sources of information

1. H. A Stettler, *Auditing Principles*, p 18

2 T C Ray, *An Operational Concept of Independence in Independent Auditing Standards*, p. 75

with respect to business activities, obligations, and resources

2. Active co-operation from managerial personnel during the course of the auditor's examination
3. Freedom from any managerial attempt to assign or specify the activities to be examined or to establish the acceptability of evidential matter
4. Freedom from personal interest or relationships leading to exclusion of limitation of the examination of any activity record, or person that otherwise would have been included in the audit

Reporting Independence

1. Freedom from any feeling of loyalty or obligation to modify the impact of reported facts on any party
2. Avoidance of the practice of excluding significant matters from the formal report in favour of their inclusion in an informal report of any kind
3. Avoidance of intentional or unintentional use of ambiguities of language in the statement of facts, opinions, and recommendations and in their interpretations
4. Freedom from any attempt to overrule the auditor's judgement as to appropriate content of the audit report, either factual matter or his opinion

Provisions have been made in the Companies Act, 1956, Chartered Accountants Act, 1949 and the Cost Accountant Act, 1959 for ensuring independence of an auditor

The Companies Act, 1956 has made the following provisions in this respect (*a*) it has laid down specific conditions which may make a person disqualified to act as auditor of a company, (*b*) the right to appoint an auditor has been given to the shareholders, (*c*) an auditor can be removed before the expiry of his term only with the previous approval of the Central Government, (*d*) a retiring auditor, who is not being reappointed, or who is being removed before the expiry of the term, has the right to make written representations to the members of the company and he can be heard orally at the general meeting

Similarly, the Chartered Accountants Act 1949 prohibits auditors the acceptance of contingent fees An auditor may be held guilty for professional misconduct, if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a "substantial interest," unless he discloses the interest also in his report The Council of Institute of Chartered Accountants of India has also, by a notification, specified that a member of the Institute shall be deemed to be guilty of

professional misconduct, if he expresses an opinion on financial statements of any business or enterprise in which one or more persons who are the "relatives", within the meaning of section 6 of the Companies Act, have either by themselves or in conjunction with such a member who has a substantial interest, unless he discloses the interest also The auditors should also try to avoid the situations when there are some conflicts between them.

AUDITOR OF A SOLE TRADER

Appointment There are no legal provisions with regard to the appointment of an auditor in case of sole trader He is appointed under a contract with the trader Their mutual agreement specifies the terms and conditions of his appointment This agreement may be in writing or oral But it is advisable to have it in writing as emphasised in *Apfel* v *Annan Dexter & Co* (1926)

He should make it clear whether his appointment is for auditing only or also for writing the books of account If he is appointed simply to maintain accounts and not to audit them, he must be cautious that his signature at the footnote of the Balance Sheet may not be utilised by his client for obtaining loans or for securing a partner or for affecting the sale of the business or even for holding him responsible as an 'auditor' for any inaccuracy in accounts The auditor in such a case must not simply sign as chartered accountant but qualify his signature with the words "Prepared from the books without verification" He must make it clear to his clients that he should not be held responsible later as to the accuracy of the Balance Sheet prepared by him.

Remuneration His remuneration depends upon the conditions of the agreement entered into with the client There are no legal provisions for this His remuneration, however, should not depend upon the results of his work but upon the basis of extent of work undertaken by him For example, it should not be fixed on the condition that he will be paid only if he could detect certain suspected fraud

Rights and Duties In a sole trading concern, his rights and duties are not statutory but customary and moral He has to exercise reasonable care and skill in the performance of his duties What is reasonable would depend upon the facts of the case He should carry on his audit work intelligently, honestly and with due care He should take pains in verifying the incomes and expenditures etc He should examine the books of account thoroughly as the transactions in most of the cases would not be numerous He should satisfy himself as to the correctness of the accounts In performance of his duties, he should obtain all the necessary informations and seek explanations, wherever necessary After he has carefully audited the accounts of the concern, he must submit a report duly signed by

him He should render his valuable advice if he is called upon to do so by his client.

AUDITOR OF A PARTNERSHIP FIRM

Audit of a firm's accounts also is not legally compulsory but an auditor is usually appointed by it.

Appointment and Remuneration The appointment and remuneration of an auditor in case of a partnership also depends upon the agreement with the client The Indian Partnership Act, 1932 is quite silent about this Thus, there are no statutory requirements for it At the time of his appointment, an auditor must see all those points mentioned earlier in case of the sole trader

Rights and Duties The rights and duties of an auditor in case of a firm also are customary and moral He has got a right to see the Partnership Deed of the firm which contains the various terms and conditions regulating the functioning of the partnership firm Similarly, he has a right to see the books of account of the firm. He has the right to seek explanations and secure informations if he feels necessary He has got the right to receive his remuneration for the audit work done by him

So far as his duties are concerned, he must perform his work with reasonable care, honesty and intelligence He must satisfy himself with regard to the correctness of the accounts He must see that the rules and regulations laid down in the Partnership Deed or. in the absence of such Deed, as given in the Indian Partnership Act, 1932, have been duly observed If they have not been observed he must bring the facts to the notice of the partners in clear words

After the examination of the books of account is over, he must submit his report bringing the correct situation of the financial affairs of the firm to the knowledge of the partners Finally, he should render necessary advice if he is called upon by the client to do so

AUDITOR OF A LIMITED COMPANY

The audit of the books of account of a company has been made compulsory by the statutes in various countries of the world. In India also, the company audit has been made compulsory by the Indian Companies Act, 1956. It contains provisions with regard to company audit and the auditor. It provides for the appointment, remuneration, removal, duties and qualifications etc, of a company auditor Sections 224 to 233 of the Act cover various provisions related to the company auditor It is the law and not the contract which governs the auditor of a company unlike the auditor of the sole traders or partnerships. These provisions are necessary to

ensure the independence* of the company auditors so that they may be able to serve the interest of shareholders of the company and arouse their confidence in general in company form of business enterprises

Appointment The provisions with regard to the appointment of a company auditor are as follows

(1) *The first auditor* of a company shall be appointed by the Board of Directors within one month of registration of the company and the auditor shall hold office until the conclusion of the first annual general meeting

In case the first auditor of the company is not appointed by the directors as provided, the company in general meeting may appoint the first auditor

(2) *Auditor in general* of a company is not appointed in the same manner as the first auditor Normally, he is appointed every year by the shareholders of the company They have to pass a resolution in each annual general meeting for his appointment The auditor thus appointed will hold office from the conclusion of that meeting until the conclusion of the next annual general meeting The company has to give intimation of appointment to every auditor so appointed, unless he is a retiring auditor, within seven days of the appointment At the same time, the auditor thus appointed in his turn is bound to inform the Registrar in writing of his acceptance or rejection of his appointment as an auditor within thirty days of the receipt of intimation of his appointment from the company Such intimation has to be given in Form No 23B of the companies (Central Government's) General Rules and Form, 1956, which is as under

Registration No of Company
Nominal Capital Rs . ...

THE COMPANIES ACT, 1956
Notice by Auditor
Persuant to section 244 (1A)

I/We . . . . hereby give notice to the Registrar of companies persuant to section 224 (1A) of the Companies Act, 1956, that I/We have received intimation dated the . . day of 19 . from . . . . Limited/Private Limited of my/our having been appointed as auditor (s) for the year ... . and that I/We have accepted / refused to accept the appointment as auditor(s) of the company

Dated the .... day of ..
19 . . . .

Signature

(3) *A retiring auditor*, by whatsoever authority appointed, shall be reapppointed, unless —

(*a*) he is not qualified for reappointment,

(*b*) he has given the company notice in writing of his unwillingness to be reappointed,

(*c*) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed;

(*d*) where notice has been given on an intended resolution to appoint some person in the place of the retiring auditor, and by reason of death, incapacity or disqualification of that person, as the case may be, that the resolution cannot be proceeded with.

(4) *An auditor not appointed at the annual general meeting of the company* may be appointed by the Central Government But it has been provided that the company must notify the Central Government within seven days of his power becoming exerciseable If the company fails to notify this fact to the Central Government the company and every officer thereof who is in default shall be liable to a fine extending upto five hundred rupees.

(5) *An auditor in a casual vacancy* may be appointed by the directors under section 224 (6) of the Act But the directors do not have power to fill the casual vacancy caused by the resignation of an auditor

(6) *Appointment on the resignation of existing auditor* Resignation of the existing auditor gives rise to a casual vacancy in the office of the auditor In terms of the proviso to Section 224 (6) (a), such vacancy can be filled by the company only at a general meeting In view of this, the company should convene extraordinary general meeting to fill the casual vacancy and make appointment of the auditor However, before giving the appointment to the auditor, the company should ascertain that the number of company auditor held by the auditor will not exceed the specified number in terms of Section 224 (IB) of the Companies Act, 1956

(7) *Special auditor* may be appointed by the Central Government under the Companies (Amendment) Act, 1960 to direct special audit in certain cases under section 233A For this purpose it may appoint a Chartered Accountant or the company's auditor himself to conduct a special audit and he will be referred to as special auditor The period for which the company's accounts will be audited by him will be as specified in the order for special audit

(8) *Cost auditor* may be appointed under the Companies (Amendment) Act, 1965 to do cost audit of certain companies He shall be appointed by the company in its general meeting at the instance of the Central Government which may direct for its cost audit A cost auditor shall be either a cost accountant within the meaning of the Cost and Works Accountants Act, 1959, or any

chartered accountant within the meaning of the Chartered Accountants Acts, 1949, or other person possessing the prescribed qualifications The provisions of section 224 of the Act shall apply to him also But he shall act in addition to an auditor appointed under section 224.

(9) *Joints auditors* may be appointed by some large concerns like banking and insurance companies in the manner discussed above Sometimes the regulations of the company require such appointment of auditors If two or more auditors are appointed responsibility will be joint

One important point in connection with the appointment of a regular auditor is that to ensure independence in his working, it is desirable that there should be continuity in his appointment Legally, he is appointed for the term of one year only, but he should be reappointed continuously for at least four or five years This will ensure protection to the auditor from being penalised by his removal when he has given independent opinion with adverse criticisms of the accounts produced by the management

New provisions of Companies (Amendment) Act, 1974 regarding appointment of company auditors: The Companies (Amendment) Act, 1974 has introduced certain radical changes with regard to the appointment of the company auditor as there has been a general complaint that there has been concentration of audit in the hands of a few established firms of auditors and has tended to create close association between the auditors and a group of companies To deal with the situation, it has been provided that no person or firm shall be appointed auditor of the specified or more that the specified number of companies

The proviso of sub-section (1) of Section 224 now requires that before any appointment or re-appointment of auditor or auditors is made by any company at any annual general meeting, a written certificate shall be obtained by the Company from the auditor or auditors proposed to be so appointed to the effect that the appointment or reappointment, if made, will be in accordance with the limits specified in sub section (1 B), as given below

The sub-section (1 B), newly introduced in the said Act, states that "On and from the financial year next following the commencement of the Companies (Amendment) Act, 1974, no company or its Board of directors shall appoint or reappoint any person or firm as its auditor if such person or firm is, at the date of such appointment or reappointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies".

It has been provided that in the case of a firm of auditors, "specified number of companies" shall be construed as specified number of companies as per partner of the firm It has been further provided that where any partner of the firm is also a partner of any

other firm or firms of auditors, the number of companies which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number in aggregate It has also been provided that where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number, in aggregate

A new sub-section (1 C) of the same Section states that "For the purpose of enabling a company to comply with the provisions of sub section (1), a person or firm holding immediately, before the commencement of Companies (Amendment) Act, 1974, appointment as the auditor of a number of companies exceeding the specified number, shall, within sixty days from such commencement, intimate his or its willingness to be re-appointed as the auditor from the financial year next following such commencement, to the company or companies of which he or it is not willing to be re-appointed as the auditor and shall simultaneously intimate to the Registrar the names of the companies of which he or it is willing to be re-appointed as the auditor and forward a copy of the intimation to each of the companies referred to therein

For this purpose, the specified number here implies (*a*) in the case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share capital of less than rupees twenty-five lakhs, **twenty** such companies, and (*b*) in any other case, **twenty** companies, out of which not more than ten shall be companies each of which has a paid-up share capital of rupees twenty-five lakhs or more.

In computing the specified number, however, the number of companies in respect of which or any part of which any person or firm has been appointed as an auditor, whether singly or in combination with any other person or firm, shall be taken into account.

Section 224 A, introduced by the said Act, provides that in certain specified case, the auditor cannot be appointed except with the approval of the company by special resolution

It provides that in the case of a company in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by (*a*) a public financial institution or a Government company or Central Government or any State Government, or (*b*) any financial or other institution established by only Provincial or State Act in which a State Government holds not less than fifty-one per cent of the subscribed share capital, or (*c*) a nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment at each annual general meeting of an auditor or auditors shall be made by a special resolution In case, the specified company fails or omits to pass at its annual general meeting any special resolution appointing an

auditor or auditors, it shall be deemed that no auditor or auditors had been appointed by the company at its annual general meeting, and, thereupon, the Central Government will appoint a person to fill the vacancy

The above provisions may be *summed up* as follows·

(*i*) *Under Section 224 (IB)*, a company or its Board shall not appoint or re-appoint any person or firm, as its auditor if such person or firm is holding appointment as auditor of the specified number or more of the companies The number is 20 of which 10 companies at least should be such as have a paid-up capital of less than Rs 25 lakhs

(*ii*) *Under Section 224* A, in case of a company in which not less than 25% of the subscribed share capital is held, either singly or in aggregate, by the specified bodies and institutions, the re-appointment has to be by a special resolution, failing which it will be assumed that no appointment has been made

VALIDITY OF APPOINTMENT AFTER CHANGE IN CONSTITUTION OF FIRM

Often a firm of chartered accountants is appointed to undertake the audit of a company It is duly valid under Section 226 (1) of the Companies Act, 1956 However, after the appointment of the firm, if there is any change in its constitution, the question arises, whether its appointment is still valid or not Such change in its constitution may arise on account of death, retirement, or admission of one or more partners The answer is that it is fully valid and there are no legal obstacles in this connection

It has been rightly stated in this regard that it is clear from the provisions of the Indian Partnership Act, 1932 that "if a partner retires or dies and the firm continues to be in practice, the remaining partners can carry on the existing assignments standing in the firm name, if the companies under audit had the knowledge of the retirement or death of the partner and had allowed the reconstituted firm to continue the assignment." Thus, a firm of the chartered accountants can undertake the audit of a company even after the change in the constitution of the firm.

It may, however, be noted that if there is a complete change in the constitution of the firm, i e , all the existing partners retire and new partners join, the reconstituted firm cannot undertake the audit as no contract exists between the company and the new partners. Under such circumstances, there would be a casual vacancy and the Board of Directors of the company can fill it, under the provisions of Section 224 of the Indian Companies Act, 1956

In case, there is a sole proprietary firm appointed as auditor of the company and, later, new partners are admitted in it, the earlier appointment would be valid. However, new partners would not be responsible for such assignments.

Remuneration According to section 224 (8) of the Companies Act, 1956, the remuneration of the auditor of a company is fixed as follows —

(i) His remuneration is fixed by the directors when he is appointed before the first annual general meeting or to fill casual vacancy

(ii) In case the appointment of auditor including "special auditor" is made by the Central Government in the circumstances mentioned earlier, his remuneration is fixed by the Central Government

(iii) In all other cases, his remuneration is fixed by the company in its general meeting or in such manner as the company in general meeting may determine

It is to be noted that for this purpose, any sums paid by the company in respect of the auditor's expenses shall be deemed to be included in the expression "remuneration"

(iv) In case the auditor's services have been requisitioned for other purposes in addition to normal annual audit, he is entitled to a remuneration in addition to the normal fee for his audit work.

Removal According to section 224 (7) of the Act, any auditor may be removed from office before the expiry of his term But it can be done only by the company in its general meeting, and with the previous approval of the Central Government

But there is an exception to the above rule relating to the removal of the first auditor who may be removed before the expiry of his term by the company in its general meeting even without the approval of the Central Government

According to section 225 of the Act, a special notice of 14 days has to be given for moving a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed A copy of such resolution shall be forthwith sent to the retiring auditor It means that no new auditor can be appointed in place of the existing one unless due notice has been given to the latter

The retiring auditor has got a right to make written representation to the company This right has been given for the first time by Companies Act, 1956 with a view to prevent the management from removing an auditor without the knowledge of the shareholders whose representative he is His representation should not exceed a reasonable length and he may request the company to notify such representation to the members of the company The company shall, unless the representation is received too late, in any notice of the resolution given to the members, state the fact that the representation has been made and send a copy of it to every member of the company to whom the notice of the meeting is sent In case the copy of the representation has not been sent to the members because it was

received too late or because of the company's default, the auditor may require that his representation may be read out at the meeting. This may be done without prejudice to his right to be heard orally. He has got a right to attend the meeting where his removal is being discussed.

There is an exception to the above right of the auditor to make representation The company may not be required to do so if the Court is satisfied on an application of the company or of any other aggrieved person that the rights are being abused to secure needless publicity for defamatory matter The Court may also order the auditor to pay in whole or in part the company's costs on such an application

For the removal of the first auditor also, the above-mentioned provisions would apply

Qualifications Section 226 of the Act lays down the provision with regard to the qualifications or disqualifications of a company auditor Section 226 (1) and (2) provides that the auditor must possess the following qualifications.

Either *(a)* he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 which requires that he should be a member of the Institute of Chartered Accountants It has also been provided that a firm whereof all the partners practising in India are qualified as aforesaid, may be appointed by the firm's name to be an auditor of a company, in which case partner so practising may act in the name of the firm

Or *(b)* he is a holder of a certificate under the Restricted Auditors Certificates (Part B States) Rules, 1956 The Central Government may, by notification in the Official Gazette, make rules providing for the grant, renewal, suspension of cancellation of such certificates and may prescribe conditions and restrictions for such purposes It is to be noted that the grant of such certificates entitles the holder to act as an auditor anywhere in India

Disqualifications Section 226 (3) of the Act provides that none of the following persons shall be qualified for appointment as auditor of a company:

(a) a body corporate,

(b) an officer or an employee of the company,

(c) a person who is a partner or who is in the employment of an officer or employee of the company,

(d) a person who is indebted to the company for an amount exceeding Rs 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of a third party to the company for an amount exceeding Rs 1,000,

(e) a person who is a director or member of a private company;

(*f*) a director or a holder of shares exceeding five per cent in nominal values of the subscribed capital But while computing the percentage, shares held by such persons as nominee or trustee for any third person and in which the holder has no beneficial interest shall be excluded ,

(*g*) if he is disqualified for appointment as auditor of any body corporate, which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company

It is to be noted that in section 226 (3), references to an officer or employee shall be construed as not including references to an auditor, and if an auditor after his appointment becomes subject to any of the above mentioned disqualifications he shall be deemed to have vacated his office forthwith

RIGHTS OR POWERS OF CO AUDITOR

The Companies Act, 1956 has conferred several powers on the auditor of a company so that he may perform his duties well and fulfil the objectives satisfactorily We mention these powers below

(*i*) *Right of Access to Books and Vouchers* The auditor has a right of access at all times to the books and vouchers of the company whether kept at the head office or elsewhere (section 227)

He has been given power to deal with the company 'at all times'' which means at any time during the business hours It is quite necessary since the auditor may have to visit and check the accounts suprisingly, specially when he suspects any irregularity in the accounts or wishes to verify the cash balances etc But in general, what the auditor does is to fix time with the directors of the company for the conduct of his audit

The terms and 'books' 'vouchers' etc also need an explanation. Here the 'books' would include not only the books of financial records, but also all the statutory, statistical and costing books The auditor may inspect even the memoranda books such as stock book, costing records and the like Thus, he may have access to any book which may be relevant for the purpose of accounts Similarly the term voucher would imply all the documentary evidences which may be helpful in substantiating the transactions entered in the books of account It includes the documentary evidences such as bills, receipts, agreements, leases, correspondence etc Thus, this provision enables the auditor to have access to all the materials which he may think necessary and which might have been used in the preparation of accounts Had this provision not been there, it would have been difficult for the auditor to carry on his work well

(*ii*) *Right to receive Information and Explanation* A company auditor is entitled to require from the officers of the company such

information and explanations as he may think necessary for the performance of his duties as auditor. The 'officer' will include any Director, Managers or Secretary etc.

This privilege given to the auditor is of immense help in the performance of his duties His powers are quite wide, as it has been left to his discretion as to what particular information he should ask for or as to on what points he needs elucidation. Thus, he may discuss any matter pertaining to the accounts of the company with the officers of the company He may ask for explanations on those points which he may not be able to ascertain from the examination of the books of account (For example, he may enquire from the directors etc for the payments which they might have received from other firms or companies if he finds it necessary) He may also need explanations on many points from the officers of the company who are familiar with the nature and technicalities of the business operations of the company. It should also be noted that it is the auditor who has to decide whether the particular explanation given to him by the officer of the company is satisfactory or not In case the officers of the company refuse to give the required information which the auditor feels necessary for the performance of his duties, he must mention this fact in his report

(iii) *Right to Receive Particulars* He has a right to get from an officer or other person any particulars or information required to be given in the Balance Sheet or Profit and Loss Account of a company or in any document required to be annexed or attached thereto (section 221)

(iv) *Right to seek Opinion from Experts.* An auditor cannot be taken to be an expert in all the areas, therefore, he has a right to seek opinions of experts in different fields whenever he feels it necessary For instance, he may seek opinion or advice from lawyers, engineers or bankers, etc

(v) *Right of Access to Branch Accounts* The auditor is entitled to visit the branch office of the company, if any, if the accounts of the company branch have not been audited by a duly qualified auditor, unless the company in its general meeting decides otherwise He shall be entitled to visit the branch office if he deems it necessary to do so for the performance of his duties as auditor He shall have the right of access at all times to the books of account and vouchers of the company maintained at the branch office But in the case of a banking company having a branch office outside India, it shall be sufficient if the auditor is allowed access to such copies of and extracts from the books and accounts of the branches as have been transmitted to the principal office of the company in India [section 228 (2)].

(vi) *Right to Receive Notices* All notices of, and other communications relating to any general meeting of a company, shall be forwarded to the auditor of the company in the same manner as it has to be sent to any member of the company (section 231)

(vii) *Right to attend General Meetings.* The auditor of a company also has a right to attend any general meeting and to be heard at any general meeting on any part of the business which concerns him as auditor But it is not obligatory on his part to exercise this right. He may or may not attend the general meeting of the company. If he thinks it necessary, he may attend it and explain his view points clearly to the shareholders of the company It becomes quite necessary, when he finds that the directors are making deliberate attempts to conceal the material facts from the shareholders or misinterpreting to them the points placed by the auditor in his report to them He should also attend the meeting when asked to do so by the management He need not answer all the questions put to him but he should answer those questions which affect his work as auditor of the company He should also correct any wrong fact related to the accounts presented to the shareholders. But he should bear in mind that this provision does not relieve him from the liability for not having submitted the report in clear words.

An auditor, however, has got no right to alter or amend the accounts of the company placed before him for the purpose of audit If he finds the need for any alteration in the accounts because they have not been kept in accordance with the Act or are misleading, he can simply persuade the directors to get them corrected If his persuasion fails and the directors do not agree to make the desired changes in the accounts, the auditor must bring the fact to the knowledge of the shareholders through his report to them

(viii) *Right to Receive Remuneration* He has a right to demand his remunerations from his client after he has completed the work of auditing It is to be noted that he is entitled for full year's fee, even though he might have been dismissed during the year, provided the remuneration payable to him was fixed in the form of annual fee (*Homer v Quilter, 1908*)

DUTIES OF CO. AUDITOR

The various duties of a company auditor imposed upon him by the Companies Act, 1956 are as follows

(i) *Duty to submit Report* A very important duty of an auditor is to give a report on the accounts of the company Section 227 (2) and (3) provide that the auditor shall make a report to the members of the company, on the accounts examined by him, and on every Balance Sheet and Profit and Loss Account and on every other document declared by the Act to be part of or annexed to the Balance Sheet or Profit and Loss Account, which are laid before the company in general meeting during the tenure of his office The details which he has to state in his report will be given in subsequent chapter It is however, no part of an auditor's duty to prepare and balance the accounts of the company unless he has been specially directed to do so. If he prepares accounts also he will be doing so in the capacity of an accountant It is the duty of the directors to prepare the accounts to be presented to the auditor for audit.

It is to be noted that powers and duties of "special auditor" appointed under section 233 A in relation to his special audit are the same as under section 227 mentioned above

The auditor has to perform his duty towards the shareholders of the company honestly by giving to them the true and fair view of state of affairs of the company, so that they may not be misled by the management He has to keep the interest of the shareholders, the real owners of the company, in his mind while submitting his report It is his duty to bring without hesitation to the notice of shareholders his dissatisfaction with the accounts or any irregularity in them or with regard to informations or explanations which he wanted to convey to the members but he could not get

His duty is not merely to check the arithmetical accuracy of the books of account[1] He should also (*a*) see that the books show the true financial position of the company, (*b*) make himself acquainted with his duties under the Articles and the Act, and (*c*) dive deep down into a matter when some suspicion occurs from the acts of the servants of the company

He has to address his report to the shareholders irrespective of the fact whether he has been appointed by them or not, except in the case of special audit under section 233A, in which case he has to report to the Central Government He has to sign the report under section 229 of the Act It is no part of his duty to see that his report has been sent or placed in the hands of the shareholders His duty is over after he has signed his report and the Balance Sheet and has sent it to the Secretary of the company[2]

The auditor does not give any guarantee as to the correctness of the Balance Sheet of the company He simply states that in his opinion it is correct

(ii) *Duty to undertake Cost Audit* An auditor may be required under section 233 (B) by the Central Government to make an audit of cost accounts of a company and report thereon where it is necessary for the purpose of obtaining a true and fair view of the affairs of the company engaged in production, manufacturing or mining activities

(iii) *Duty to certify Statutory Report* The auditor has to certify the Statutory Report as correct according to section 165(4) The Statutory Report shall first be certified as correct by not less than two directors of the company one of whom shall be managing director, where there is one After the Statutory Report has been so certified, the auditor shall, in so far as the Report relates to the

1. *Registror v P M Hedge*, 1954 *Dy Secretary to the Government of India, Ministry of Finance v. S N Dasgupta*, 1956

2 *Re Allen Craig & Co (London) Ltd*, 1934.

shares allotted by the company, certify that the cash received in respect of such shares and the receipts and payments of the company are correct

The provision is not applicable to the private companies since these companies do not have to hold statutory meeting under the Act

(*iv*) *Duty to certify statement in Prospectus* The Prospectus issued by an existing company, under section 56(1), should contain a statement with regard to profits and losses and assets and liabilities of the company and its subsidiaries The auditor has to certify such statement in the Prospectus

In this connection, the auditor has to submit a report under Schedule II, Part II with regard to ,

- (*a*) profits and losses made during each year of the five preceding financial years ,
- (*b*) the assets and liabilities of the company on the last date on which the accounts were made up,
- (*c*) the rates of dividends, if any, paid by the company in respect of each class of shares in the company for each of the five financial years immediately preceding the issue of the Prospectus ,
- (*d*) the particulars of each class of shares on which such dividends have been paid,
- (*e*) the cases in which no dividends have been paid in respect of any class of shares for any of those years ,
- (*f*) in case the accounts have not been made up in respect of any part of the period of five years ending on a date three months before the issue of the Prospectus, he should state the fact in his report

(*v*) *Duty to report regarding Declaration of Solvency* In the event of declaration of solvency of company by its directors, while there is a proposal to wind that up voluntarily, such declaration shall have no effect unless it is accompanied by a copy of report of auditors of the company (prepared as far as circumstances admit) in accordance with the provision of the Act Such report should be given on the profit and loss account of the company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration It should also pertain to the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as that date [section 488 (2b)]

(*vi*) *Duty during Investigation of Co* Section 240 imposes a duty on the auditor in the event of investigation of the affairs of a company as follows —

(*a*) to produce to an inspector all books and papers of, or relating to the company, or as the case may be, of or relating to the other body corporate, which are in his custody or power, and

(*b*) otherwise to give to the inspector all assistance in connection with the investigation which he is reasonably able to give.

(*vii*) *Duty to Make Enquiry under Sec.* 227 (IA) An auditor has to make enquiry under Section 227 (1A) on the following points as required after the amendment of the Act in 1965.—

(*a*) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company or its members,

(*b*) whether transactions of the company which are represented merely by book entries are not prejudicial to the interest of the company,

(*c*) where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company,

(*d*) whether loans and advances made by the company have been shown as deposits,

(*e*) whether personal expenses have been charged to revenue account,

(*f*) whether it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading

(*viii*) *Duty to include certain specified matters in Report under Companies (Auditor's Report) order, 1975.* which came into effect from January 1,1976, o include certain specified matters in his report under section 227 This Order applies to—(a)manufacturing, mining or processing companies, (b) companies supplying and rendering services (c) trading companies, (d) companies engaged in the business of financing, investment, Chit fund, nidhi, or mutual benefit societies. Differet matters have been specified in case of different types of companies Some matters, for example, are auditor has to comment on terms and conditions of loans taken from parties in which the directors are interested or which are under the same management, or he has to look into and report on the prices paid for stores, raw materials or components purchased from parties in which directors

are interested or he has to offer comments on material audit system or internal control and maintenance of records relating to fixed assets etc [1]

The above-mentioned statutory duties of an auditor may be *extended but they cannot be restricted either by the Articles of Association of the company or the directors* Burkley J in *Newton v. Birmingham Small Arms Co Ltd* (1906), held that no Articles can deprive the auditor of his statutory duties of reporting to the shareholders on all matters pertaining to the accounts of the company, and that Articles purporting to do so are void *ipso facto* Every auditor should see that the Articles of the company under audit do not contain such provision He should see whether they extend his duties and must also attend to such extended duties

Status of the Company Auditor (1) The auditor, in general, is the *agent of the shareholders* of the company for the purposes of audit of accounts of the company Usually, he is appointed by the shareholders and his remuneration is also fixed by them except in certain circumstances mentioned earlier He is given access to the books of account etc and is entitled to acquire any information or seek explanations He has to submit his report to the shareholders whom he has to give independent opinion as to the financial situation of the company For all these purposes he works as an agent of the shareholders But he is never the agent of the directors of the company

The general opinion is that the auditor is an agent of the shareholders but there is difference on the point as to how far he is an agent of the shareholders In *Spackman v Evans* different views were expressed Lord Cranworth stated "The auditors may be agents of the shareholders, so for as relates to the audit of the accounts For the purpose of the audit, the auditors will bind the shareholders " Lord Chelmsford dissented from the general view of taking the auditor as an agent He said, "It seems to me that it would be unreasonable conclusion, from this mode of appointment of these officers, that they were thereby constituted agents so as to conclude the shareholders by their knowledge of an unauthorised act of the directors "

It is, however, clear that an auditor should not be deemed to be agent for the shareholders in the following respects —

(*a*) The principle that 'the knowledge of the agent is the knowledge of the principal' does not hold good If the auditor has acquired any information in the course of his audit the shareholders are not bound by it.

(*b*) If the auditor gives any information to the directors, it cannot be taken to be the communication of information to the agent (the directors) which will bind the principal (the shareholders)

1. For details see chapter 25 on Company Auditor s Report.

(2) Besides being agent of the shareholders, the auditor is an *officer of company* also but only for certain purposes as specified in the Act In general, however, he is not an officer in the real sense of the term As stated in Halsbury's Law of England, "any person, who is regularly employed as part of their business or occupation and participates in conducting the affairs of the company, may be officer of the company" Thus he may not be taken to be an officer of the company as (*a*) he does not take part in conduct of affairs of the company, and (*b*) he does not have power of directing persons also However, according to section 2 (30) (*c*) of the Companies Act, 1956, he is an officer for purposes of sections 477, 478, 539, 543, 545, 621, 625 and 633 Lindley L J, in *re London and General Bank* (1895) said "It seems impossible to deny that for some purposes, and to some extent, an auditor is an officer of the company He is appointed by the company and his position is described in the section as that of an officer of the company He is not a servant of the directors On the contrary, he is appointed by the company to check the directors, and for some purposes, and to some extent, it seems to me quite impossible to say that he is an officer of the company" Similar views were expressed in *re Kingston Cotton Mills Co Ltd* (1896)

A casually appointed auditor, however, is not an officer of the company as was held in *re Klestein Counties Steam Bakers & Milling Co Ltd.* (1897)

It is to be noted that an auditor is not an employee of a company if he is not appointed like other employees, he works independently, according to his wishes, he need not work himself and may take help from others paid by him, and he undertakes audit work of various concerns simultaneously

Auditor's Lien There is no settled opinion with regard to the auditor's lien over the books of account for the remuneration due to him for auditing those books The Companies Act, 1956 is silent on this question But it provides that the books of account of a registered company be kept at the registered office of the company or at such other place in India as the directors think fit It is also provided that the books of account shall be open to inspection by any director during business hours (section 209) In view of this provision, it is questionable whether the auditor can have any lien over the books of account It may be said that he can exercise this since the law has not deprived him from exercising such rights of lien over the books of account However, he should give facilities to the directors for inspecting the books whenever they desire to do so

So far as his lien over working papers is concerned, the question of right of lien over them does not arise at all since they are the property of the auditor He is not bound to hand over these working papers to the client.

The distinction between the lien of an accountant and that of an auditor over the books should be clearly understood It has been

held in several cases that an accountant who has been responsible for preparation of accounts has a particular lien over the books of accounts, for the charges incurred for writing such books [1]

In *Chantrey Martin & Co v Martin* (1953), the Court of Appeal held that the following documents were the property of the firm of accountants who acted as auditors of a company working papers and schedules relating to the audit, draft accounts of the company the accountants' office copy of the final typed accounts of the company, notes and calculations relating to these draft accounts made by a partner of the firm of accountants, and the draft tax computation prepared by an employee of the firm of accountants

MANAGEMENT SERVICES BY AUDITOR

It is not commonly known that besides giving the traditional services related to accounting, audit and taxation, an auditor may also be required to give specialised services to the management They are called "management services" which may be rendered in the following directions[2]

(i) *Financial matters* Consulting work rising from the audit, including inventory valuation policies, depreciation procedures and establishing bases for expensing repairs and maintenance

(ii) *Assistance to company secretary or accountant* Advice on investment problems, borrowing problems, credit policies, cash, management and shareholders' relations

(iii) *Accounting systems and procedures* Design of financial accounting system, creating internal controls, development of cost accounting systems, conversion to machine account procedures and design of internal financial statements

(iv) *Information or control systems* Design of inventory control methods, design of production control procedures, consulting on personnel record keeping problems, setting up information systems for marking and sales and design of budgetary control systems

(v) *EDP and management sciences* Conversion to Electronic Data Processing accounting systems, application of operations research techniques, development of analytical tools for decision-making use of computers in desision-making, application and development of long-range planning techniques

These services may be needed by the management with a view to increasing the efficiency of the undertakings In fact, it has been

1 *Burleign V Ingram Clarke, Ltd (1901), and re hill ex-parte Southall* 1848).

2 Bhandari, Management Services Ro'e of Chartered Accountants," *The Financial Express* May 20, 1968

rightly remarked that "accountancy profession without management services is like an eye specialist who merely prescribes spectacles for an eye deficiency when the whole trouble was caused by some serious illness of the eyes"

It has been argued that such management services should be rendered by persons other than practising accountants But such an argument is not correct as these accountants alone are the most competent persons for rendering such advisory services They are in constant touch with the financial records of different kinds of business concerns by auditing their accounts or by rendering taxation services to them This enables them to know about the weaknesses and special difficulties of these concerns They are, therefore, in a better position to keep the management well-informed with the interpretation of financial and other records and thus avoiding any loopholes in financial planning and disaster

Another important point which has to be considered in this connection is whether an auditor can remain independent while rendering such services to the management The American Institute of Certified Public Accountants Committee is of the opinion that a practising accountant may render management services without losing his independence, provided he does not enter into the decision-making process at the same time. Similar views were expressed at the 12th Annual Congress of the Australian Chartered Accountants' Research Society (N S W Division)

It may, however, be noted that inspite of the fact that he can maintain his independence while rendering management services to his client, it would be advisable that those accountants who audit the accounts of the client should not be required to render these services It has been rightly remarked that "No matter how influential advice is neither the offering of it nor the acceptance of it gives the adviser either the authority or the responsibility of management"

QUESTIONS

*1. Explain the various qualities required in a successful auditor

2 "The auditor should have a full share of that most valuable commodity—common sense" Explain this statement and discuss the various qualities of an auditor

3. What do you understand by the independence of an auditor? Discuss the importance of auditor being independent

4. Explain the provisions of Companies Act, 1956 regarding the appointment, remuneration and qualifications of a company auditor.

5. Explain clearly about the status of a company auditor.

6. How can a company auditor be removed?

7 Who cannot be appointed a company auditor? Also explain the validity of appointment of a firm of auditors af e the change in its constitution

8 Explain the rights and duties of a company auditor

9 What do you understand by the "Management Services by Auditor?" Explain its importance.

10 Write short notes on

(a) Auditor's lien,

(b) Disqualification of an auditor,

(c) Status of a company auditor,

(d) Auditor of a sole trader and partnership firm

11 Give your opinion whether the following can be appointed auditor of a company

(a) A firm of chartered accountant in practice a partner of which is secretary of the company.

(b) A chartered accountant in practice owing Rs. 500 to the company

(c) A chartered accountant in practice holding 7% of shares in a company

4

Planning the Audit

The audit of accounts of a concern involves sound planning, conduct and judgment The auditor must devote time to thinking before acting because he has to face several problems in the course of audit He has to determine the future course of action, frame his policies, lay down programmes and procedures and divide carefully the whole work amongst the staff Much of his efficiency and success would depend upon how well he has been able to plan his work It would involve consideration of various points described below

Arrangements with the client An Auditor should first consult the client about certain aspects of audit of the concern before finalising any agreement For instance, he should have prior agreement about the nature of audit, period by which the audit report is to be delivered and remuneration etc He should consult about the extent of his duties Limitations as regards internal controls etc should also be discussed as they effect his work He has to enquire about the nature of audit and also whether it would be annual, continuous or interim audit So far as the auditor's report is concerned it may be in any form except in case of a company If the client needs it in any particular form that should be discussed The date on which the report has to be submitted is an important point as it limits the period of audit For remuneration also he should reach an agreement, whether it would be on a flat-fee basis, a per diem basis plus travelling expenses, if any, or a per diem basis plus expenses with a minimum total fee An auditor generally prefers a per diem basis so that if any unforeseen event arises that may be fully explored without any monetary loss to him Thus, an auditor should consult his client about all the relevant matters on which he may need clarification

Audit Memorandum Having sought clarifications on the above points, the auditor should try to gain familiarity with the nature and various other aspects of the client's concern. He should prepare a memorandum containing all useful information regarding the business of the client It should also contain all the conditions relating to audit The object of preparation of the memorandum is to record relevant general information about the concern which may be of practical use to him while conducting the audit It is necessary to know about the organisation, its personnel, its methods

of operation, its policies about sales, advertisement, investments depreciations or reserves etc If it is a first audit, it will have to be prepared thoroughly so as to cover various aspects about the concern If audit has been carried on earlier, only changes, if any, in the various items should be noted Sometimes the auditor just talks to the officers of the concern and collects all these informations and does not keep such records in writing But it is advisable to prepare such a memorandum

According to Eric L Kohlar,[1] an audit memorandum, in the event of first audit, should contain the following points —

1 Ownership and control ; reorganisations in recent year.
2 A brief history of the net-worth accounts.
3 Principal kinds of products
4 Nature of the market in which the products are sold.
5 Price conditions and trend of sales
6. Advertising methods
7 Location of plants and offices
8 Character and adequacy of manufacturing facilities.
9 Sources of raw materials and trends in prices
10 Names and inter-relation of principal officers
11 Responsibility of controller
12 Books of account, nature of and where kept
13 Who gets controller's monthly reports and how they are used
14 How this year differed from last year : new products, new equipment, changes in cost, financial problems
15 How next year will differ from this year , changes in production, plan, costs, management
16 Purposes of investments
17. Purposes of contingency and similar reserves.
18. Subsidiary ccompanies and how they are operated and controlled
19 Special problems raised by the management opinions of internal controls, accounting policies, costing methods, promptness and accuracy of internal reporting
20 Tax returns preparation or review.
21 Preparation of government reports.

The possession of above-mentioned informations would facilitate his actual task of audit to a great extent.

1 *Auditing*, p 89

PROCEDURAL REVIEW IN NEW AUDIT

The auditor, having finalised the agreement to undertake the audit of the client's concern, should try to ascertain the precise nature and scope of his duties in writing

He should, then, carry on the procedural review of his client's concern which is more important in case of a first audit of the concern. By procedural review we mean "a study of the structural and operating characteristics of the organisations under examination" It is advisable to gather useful informations about the operation of the organisation *He should know beforehand the nature of the business, its management and the method of operation* He should make thorough enquiry about these things If the nature of the concern is technical with which he is not familiar, he must familiarise himself with all those technical details otherwise he will not be able to carry on the audit work effectively

In case of a company, it is essential *to know the top management and how it operates,* so as to ascertain where responsibilities reside and the persons with whom policies and controls may be discussed For this, organisational and functional charts may be obtained and studied if there are any If that is not available, he should prepare a chart himself *He should also try to be familiar with the policy of the Board* of directors in delegating authority to the management and how efficiently the management controls the staff He should also *study the business policies* in general "how they originate, how they are given expression, who is responsible for their operation, who follows up, enforces, and reports on them, and finally, how they are periodically reviewed and co-ordinated at the top-management level"

He should *enquire about the adequacy and reliability of internal controls* It is very essential to know to what extent he would be able to rely safely on the internal check already existing In his review of the internal check system prevailing he should try to gather the informations personally and not to rely upon the statements made by the client's staff He should ensure the reliability of the system by testing it. He should mark the weakness, if any, in the system as his testing procedures would depend upon this

The *system of book-keeping and accounts employed in the concern should also be studied carefully* A complete list of all the books in use in the concern should be obtained by the auditor The names and respective duties of members of the staff should also be ascertained. He should make a study of relevant important documents such as Partnership Deed in case of a firm and the Memorandum of Association and the Articles of Association in case of a company

He should also *study the previous Balance Sheets* to be familiar with the various assets and liabilities If the books of account of the concern have been subject to prior audits, he should scrutinise the published accounts and statements for his guidance and use

(Specimen)

AUDIT PROGRAMME OF M/S LTD

Year Months	Cash Book balanced	Bank balance checked	Cash Book vouched	Petty Cash Book vouched	Cash Book posting (Dr side) checked	Cash Book posting (Cr side) checked	Bought Ledger vouched	Bought Ledger Cash Postings checked	Sales Book vouched & Postings checked	Return Books vouched & Postings checked	Purchase Book & Postings checked	Journal vouched	Stock Sheet checked	Bought Ledger balance checked	Sales Ledger balance checked	General Ledger checked	Traial Balance checked	Profit & Loss A/c checked	Balance Sheet checked	Remarks
January																				
February																				
March																				
April																				
May																				
June																				
July																				
August																				
September																				
October																				
November																				
December																				

INSTRUCTIONS TO THE CLIENT

The auditor should issue a few instructions to his client, before actually starting the work of audit In general, he may issue the following instructions

(1) All the books of accounts should be finalised and balanced and trial balance and the final accounts should be duly prepared, if not

(2) The file of vouchers should be kept ready and the vouchers should be arranged datewise, serially

(3) File of all the important papers, contracts, legal documents should be duly prepared

(4) Schedule of debtors (with details about good, bad and doubtful debtors) and the creditors should be prepared

(5) Schedule of all the investments with the details of securities held should be prepared

(6) A statement regarding valuation of stock and the stock-sheet should be kept ready.

(7) A schedule of all the prepaid or outstanding expenses and accrued income or income received in advance should be duly prepared

(8) A statement regarding the capital expenses and the deferred revenue expenses should be kept ready

(9) A certificate regarding cash in hand and cash at bank, on the closing date should be kept ready and if the bank reconciliation statement has not been prepared, the same should be duly prepared

(10) A list of all the books of accounts maintained and the names and designation of all those who handle them should be prepared

Audit Programme. An audit programme is a written plan containing exact details with regard to the conduct of a particular audit It is comprised of a set of techniques and procedures which the auditor plans in the audit of accounts of his client to achieve his objectives fruitfully, efficiently and timely A well-conceived, carefully drawn and executed audit programme gives order, points, and coherence to the audit An experienced auditor may get active cooperation from his staff with the help of a sound scheme drawn out by him But some form of a written programme ought to be there, whether it is audit of a big concern or small It involves considerable amount of thinking and planning on the basis of past experience The audit memorandum, mentioned above, would be of much use in the preparation of audit programme It should, in broad outline, contain the work to be done, members of the staff responsible for the same and the time allotted and consumed in each

section of the audit The time estimates, however, need not be disclosed to the auditor's assistants, though they may be given detailed instructions, oral or written, about the work to be done. He should pay special attention to various aspects of the concern to be audited before he finalises his audit programme. Some firms employ a standard form of audit-programme and use it in all the cases But it is not advisable to have a standard form of programme as it would discourage initiative on the part of the auditor's staff. Moreover, it should also be kept in mind that no two audits, even in the same line of trade, would present the same set of problems. Thus, if the audit work has to be carried on efficiently, it is necessary that the audit programme should be chalked out carefully after giving due consideration to the particular requirement of each case.

The audit programme should also be *flexible* It must be chalked out in such a manner that if there may be any need for revision that may be carried out without difficulty Unless frequently revised it may become out of date also It should be changed in the light of experience gained in the course of audit

Advantages Today, audit programme has become a highly important and useful document for every auditor, as it not only constitutes plan of work but also provides a basis for supervision and control of audit work It also specifies the extent and manner of checking and verification to be carried out in different areas The following advantages may accrue if audit is carried on with the help of the audit programme

(*i*) Every essential part of the work of audit can be duly carried on and there is less chance of its being overlooked or omitted. The auditor may easily know about the progress of the work done at any point of time simply by looking at the programme

(*ii*) Division of work among the juniors can be easily made and in case of any junior going on leave or leaving the work there will be minimum of dislocation in the work which can be resumed by another without any difficulty

(*iii*) It serves as a guide to the juniors who will not need repeated instructions

(*iv*) Audit work can start immediately and the work can be easily planned and phased

(*v*) It serves as a ready check-list of procedures to be applied and the work already finished

(*vi*) Supervision and control of the work can be undertaken easily and conveniently as every work is undertaken in a planned way

(*vii*) The auditor is able to work more efficiently and effectively while carrying out audit of several concerns simultaneously. In peak seasons, such planning is a must to save time and avoid confusion

(*viii*) The responsibility for any mistake or negligence on the part of a clerk can be clearly laid down as the work allotted to him is already noted and he has to affix his signature in the programme every day against the work performed by him

(*ix*) It may also result in uniformity in the work done if similar programme is followed from time to time

(*x*) It may be used as an evidence by the auditor in the Court, when necessary to prove that there has been no negligence and the work has been completed

(*xi*) If the auditing is carried on with the help of audit programme the whole work can be completed in time, methodically and honestly

Disadvantages There are, however, certain disadvantages also if the audit is carried on with the help of audit programme

(*i*) The audit work by the juniors may become mechanical and they may lose initiative and interest They have to do what they are asked to do and not what they feel like doing

(*ii*) The audit programme, howsoever thorough, may not be complete and certain items may be left from being checked

(*iii*) It may amount to rigidity in the work of audit unless frequent review of the changes is made and inserted in it

(*iv*) Procedures may be adopted which may not be suitable or appropriate to the circumstances of the client.

(*v*) The periods and the records which are required to be tested may not be varied systematically and the extention of programme indicated by the errors noticed in the course of test checking may not be made

(*vi*) They would fail to take into account any special circumstances of the client or to the development of any new or unusal features in his business [Pacific Acceptance Corporation Ltd *v* Forsyth & Others (1970)]

Precautions The above mentioned disadvantages or shortcomings may be removed if the following precautionary measures are taken :—

(*i*) The audit assistants should be duly consulted while preparing the audit programme.

(*ii*) The auditor should thoroughly review the internal control system prevailing in the client's concern specially noting changes, if any. He should find out areas of weaknesses and amend his programme accordingly so that these areas may be covered thoroughly.

(*iii*) The audit programme should also be changed if the auditor finds that some new line of business or new system has been

adopted by his client On the basis of such information, he should recast his audit programme

(iv) The juniors, who are actually undertaking audit work, should be encouraged to come forward with their suggestions so that their independent judgement and initiative may not be curbed

(v) The auditor should make efforts to change the audit programme from time to time, even if such changes may not be required so that it may not become completely stereotyped This will also avoid audit work from becoming too much mechanical

(vi) The juniors or audit assistants should be explained from time to time that the programme provides the minimum level of tests to be undertaken by them and they may seize the opportunity to extend it as and when necessary, using their own discretion.

Audit Note Book For each individual audit an auditor usually maintains a separate audit note book in which he keeps the records of all important matters which he comes across while conducting the audit These notes help him to a great extent in future, specially in subsequent audits of the same concern If the auditor is charged with negligence in his work, he may produce the audit note book as evidence and show the exact work done by him and defend himself from being put in a difficult situation Moreover, it also facilitates him in appraising that all the important items have been checked The book should be maintained clearly, completely and systematically[1] but should not contain the notes of unimportant matters which should be settled as they arise

The Audit Note Book, in general, contains the following points :—

1 Extracts from various legal documents, memorandum of association, Articles of Association, minutes, contracts, agreements etc., in case of a company and Partnership Deed in case of firms.

2 In the first audit, all the technical terms and matter used in the business

3 A complete record of exact nature of the work done.

4 A record of all missing vouchers, invoices etc., duplicates of which have to be obtained

5. Notes about all the errors or frauds discovered

6 Notes which may be of use in audits in future.

7. Points for which queries were made, and further explanations and clarifications needed

8 Extracts from all correspondence entered into with the bankers, debtors or creditors etc.

1 In *London and General Bank* (1895), Lord William observed that it was necessary to maintain a systematic record of all queries

9 Extracts from various certificates obtained by the officials or the bankers.

10. A copy of the audit programme.

Audit Working Papers An auditor usually comes into possession of various papers and documents, while carrying on the audit of his client's business These papers are known as working papers "This term designates the file of analysis, summaries, comments and correspondence built up by him during the course of the field work of an audit engagement " They consist of schedules of debtors and creditors certificates from the banks about the bank balance of the client, safe custody of documents etc , certificates obtained from the officials with regard to the stock-in-trade or bad debts or outstanding expenses, copies of correspondence entered into with debtors or creditors etc , and a copy of the auditor's report Thus, they may be in different forms and may consist of small narratives and elaborate account summaries

These papers are of great use to the auditor for reference in the future, specially when there is suspicion of frauds or some facts being concealed from him They may be helpful in supporting the facts and opinion given in the report by him They contain informations on various points with regard to the audited concerns which may arise in subsequent period of audit Moreover, as these papers are filed and preserved by an auditor, they serve as index of his achievements and past records "An auditor is often judged—and quite properly so—by the character of the working papers prepared by him or under his direction "

An auditor should try to keep control over these working papers which should not be left unattended in the client's office They should be kept locked Such control is necessary for the reason that if these papers are accessible to the client's staff, they may do some alteration in them or may get some valuable information which should not be available to them Such working papers are the property of the auditor and he cannot be compelled to hand them over to the client or others The question of ownership of such papers arose many a times and now it is well settled that the auditors are the owners of such papers and they need not hand them over to others [1]

If such papers are handed over to the clients, an auditor will not be able to defend himself in future if any dispute arises

However, the right of lien on such papers is different from the lien on books of account The auditor has the right of lien on books of account and documents of the client until the fee is paid to him, provided he also did accountancy work

Division of Wrok between Senior and Junior Clerks For the efficient and economic conduct of audit, it is desirable that the work

1. *Chantrey Martin & Co v Martin* (1953).

may be carried on by two or more audit clerks However, the number of persons required would depend upon the amount and character of the work to be done Usually the work is divided between junior and senior audit clerks who work under a principal auditor In a large professional organisation, it may consist of some supervising auditors for the supervision of all concurrent audit engagements Organisation of a large audit firm may consist of principals, auditors, assistants and office-staff The senior partners, junior partners, managers or supervisors work as principals The auditor-in-charge and the seniors work as auditors , the semi-senior and juniors work as assistants Office staff may consist of office assistants, clerks and stenographers

A general procedure for the division of work between the seniors and juniors cannot be laid down since the conditions in different audit vary to a great extent However, the distinction between the juniors and the seniors for this purpose neet not be made by age but by the skill and experience in their profession There is a great deal of hard work and drudgery involved in audit work and the seniors should be confined to such matters as they are best qualified to handle They should delegate some work to one or more juniors but should have supervision over them These juniors will work under the instructions from their senior and will be responsible directly to him

The Job of Senior The contact between the principal and the client should be through the senior The principal should convey all the important matters to his senior The nature and order of the work are decided by the senior He then assigns work to the juniors who will follow, in general, the methods outlined by him He should also guide his juniors on various points that may arise during audit He should give instructions concerning the forms and contents of working papers prepared by him It is necessary to bring uniformity in the matter If the juniors follow different procedure, the senior may have to revise it and that will be wastage of time He has to decide about the extent of items which have to be sampled, if so required If any point needs discussion with the client, it is the senior who discusses rather than leaves it to the junior

He should personally enquire into certain matters such as calculation of stocks, adequacy of reserves, depreciation, contracts etc , and all matters involving accounting principles He should also study the various important documents which may affect his audit such as Partnership Deed, Memorandum of Association, Articles of Association and the Minutes etc

He has to submit the final accounts together with all the notes taken by him during the audit to his principal who then writes reports certifying the final accounts of the client Thus, the job of the senior is quite responsible one and he may be held responsible in future in the event of any negligence

The Job of Junior The junior works directly under the senior. He has to carry out all the instructions given by the senior and should not interfere with the procedures he has been instructed to follow. The senior should not assume any arbitrary attitude towards him as it may mar his efficiency. He should, however, invite suggestions and encourage free discussion in case there is any point of doubt in his mind to encourage free thinking and stimulate efficient work. The junior should not carry on his work mechanically but should try to grasp the transactions well before passing them and should seek guidance from his senior, whenever necessary.

The nature of work assigned to the junior is a routine one and requires less skill and technical knowledge. He may be assigned the duty of examination of original records with all the available documentary evidences or vouchers, casting of subsidiary books, posting of such books into ledger, vouching of the receipts and payments, verification of cash balances, journal entries, adjustments. He will check the stock and wage sheets. He will count the cash notes, receivables and securities etc. He may also be entrusted with other related matters. Sometimes a part of the work of juniors may be examined by the senior himself. At other times, he may be left practically all alone to do the job and the senior may join him for occasional checking only. He may even be given a chance to act as senior. In case of any doubt, he should make note and discuss it with his senior. He should avoid discussion with the staff of the client and co-operate with his senior whole-heartedly following the instructions given to him.

QUESTIONS

1. Discuss the steps which you would take, as an auditor, for the procedural review of a new audit.

2. You have been appointed an auditor of a firm for undertaking annual audit. What steps would you take before actually starting the audit work.

3. What is Audit Memorandum ? Explain its content.

4. What is Audit Programme ? What are its advantages and disadvantages ? Explain them fully.

5. How would you plan the audit of a concern for which you have been appointed ?

6. What is Audit Note Book ? Explain its contents.

7. What are the Audit Working Papers? Explain its advantages and discuss as to who has lien on such papers.

8. How would you divide the work of audit between your junior and senior clerks ?

9 As an auditor, what instructions you would give to your client before actually starting the audit programme?

10 Write short notes on

(a) Audit Note Book

(b) Auditor's lien of working papers

(c) Specimen of Audit Programme

(d) Job of junior clerks

(e) Flexibility of Audit Programme

5

The Internal Check

~~In a~~ relatively larger concern the proprietor or the management is unable to supervise everything personally That may give an opportunity to the employees to indulge into fraudulent practices It becomes, therefore, necessary to evolve internal means of securing the desired control over accounting, cash and operation of the business as a whole) The need for such control went on increasing day by day with the increase in the size of business concerns and separation of management from ownership

Internal Control

In the earlier days, the object of *internal control* was quite narrow one It was simply viewed as one involving certain checks and procedures to prevent direct financial fraud or misappropriation of property Today, the concept has assumed greater significance, but it does not imply that the old concept of control, as an aspect of administration, has now been completely relegated to the background However, it is to be recognised that the major issues in relation to control are fast developing It involves even keeping the administrator posted with the up-to-date information which reflects the result of policy and which would also provide a sound basis for ascertaining the future course of action In brief, *it involves various methods and procedures, adopted in an organisation with a view to safeguard its assets, to ensure that the accounting and statistical data produced are reliable and accurate , to promote greater efficiency in operation , and to carry out effectively general policies as laid down by the management*

Some of the definitions of the internal control are as follows

In the words of *W W Bigg*, internal control "is best regarded as indicating the whole system of controls, financial and otherwise, established by the management in the conduct of a business, including internal check, internal audit and other forms of control " Thus, it has been made clear by him that the internal control is a broader term which includes financial and other forms of control and includes internal check and internal audit

The *American Institute of CPAs* has given its definition in a different way in the following words, "Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies "[1] Thus, it has taken the internal control in a very broad sense which includes all the systems of control adopted in the business organisation

According to the *Council of the Institute of Chartered Accountants in England and Wales*, internal control has been defined as "the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records "[2] This has also enlarged the scope of internal control quite considerably It has been rightly stated that "The scope of internal control, according to this definition, extends beyond accounting controls and includes all operational controls like quality control, work standards, budgetary control, periodic reporting, internal checks, internal audit, policy appraisals, quantitative controls etc " Thus, it, undoubtedly, consists of many aspects related to control in the organisation

Two important areas of the internal control, besides internal check and audit are :

(a) administrative control, and (b) accounting control.

The distinction between the two should be understood clearly An accounting control involves adopting measures so that all the transactions may be duly recorded, as authorised and executed by the management of the concern It also involves adoption of generally accepted accounting practices It should ensure that the accounting records are such that they can be duly relied upon At the same time, it would involve proper maintenance of the assets of the concern. In this connection, it has been rightly pointed out that the accounting controls are concerned mainly with the "plan of organisation and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records "

On the other hand, the administrative control refers to the system which is related to the decision-making processes which ultimately lead to the authorisation of the transactions of the concern Such controls do not have direct relation with the accounting controls and the financial records. In this connection, it has been rightly

1 *Statement on Auditing Standards*, issued by the Committed on Auditing Procedure of the American Institute of Certified Public Accountants, New York, p 15

2 *Internal Control*, Statement No U 4, Members' Handbook The Institute of Chartered Accountants in England and Wales, London, 1964

stated that the "distinction between accounting controls and administrative controls is significant An auditor has to primarily undertake a detailed review of the accounting controls since these have a direct and significant bearing on the reliability of financial statements Administrative controls, on the other hand, have only a remote relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the reliability of financial records " Thus, it is quite necessary that the auditor should make a distinction between the above two types of controls and he should pay more attention to the accounting controls and should bother about only those administiative controls which have a direct bearing upon the financial statements and records

Accounting controls cover many aspects, as mentioned earlier, but from the auditor's point of view, it mainly comprises of the internal check and internal audit We have already discussed about the internal audit earlier in Chapter 2 and here we shall confine our study to internal check

Internal Check

The whole system of accounting needs to be organised in such a manner that it may ensure some sort of check without incurring additional financial burden To meet this end, the method of internal check has been devised It is an arrangement of the duties of members of staff in such a manner that the work performed by one person is automatically and independently checked by another For example, in case of cash sales, the salesman should not be allowed either to deliver the goods to the customer or receive money from him The cashier will receive cash, the gatekeeper will deliver the goods and the accountant will make entry in the Cash Book Such an arrangement amounts to division of labour which in itself enhances efficiency This also brings about an automatic and independent checking by one another Each employee operates independently but it does not involve duplicating the work of the other This reduces the possibilities of frauds, errors or irregularities to the minimum unless there is a collusion between them The job of the management would, then, be simply to enforce the system effectively to bring about automatic control over the staff

Definitions of Internal Check

Having understood its meaning, let us see how internal check has been defined Some definitions are given below

According to *F R M De Paula*, "An internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently

checked by other members of the staff "[1] According to this definition, in practice there is no difference between internal check and internal audit But we should not take one to be the substitute of the other as they are different means of securing internal control They differ from each other in many respects as discussed later

L R Dicksee defines internal check as "such an arrangement of accounting routine that errors and frauds are automatically prevented or discovered by the very operation of the book-keeping itself "[2] This definition is not so clearly worded as the earlier one

Spicer and Pegler state "A system of internal check is an arrangement of staff duties whereby no one person is allowed to carry through and to record every aspect of a transaction, so that, without collusion between two or more persons, fraud is prevented and at the same time the possibilities of error are reduced to a minimum "[3] It is a comprehensive definition clearly stating the meaning and objectives of internal check

According to the *Council of the Institute of Chartered Accountants in England and Wales*, the internal check implies a system of instituting "checks on the day-to-day transactions which operate continuously a part of the routine system whereby the work of one person is proved independently or is complimentary to the work of nother, the object being the prevention or early detection of errors or fraud "[4] The theme of this definition is also more or less the same, as mentioned earlier

Objects of Internal Check

The objects of internal check system are to minimise the chances for the commission of errors or frauds , to enhance the efficiency of the employees , to avoid any omission of any transaction from being recorded But in a modern large-scale business organisation, the objects of internal check are much more widened than simply to minimise the possibilities of frauds or irregularities and errors *Howard Stettler*, a noted American author, is of the view that "simple steps taken by management to safeguard cash and to check the clerical accuracy of the book-keeping" is an elementary form of internal check and was adequate earlier when the size of the business organisation was not large as today Therefore, now there is a need for broader form of internal check to accomplish the following objectives

1 *The Principles of Auditing*, p 10

2 *Auditing*, p 48

3 *Practical Auditing*, p 33

4 *Internal Control*, Statement No 44, *op cit*

(i) Ensure that the accounting system produces reliable, current, and adequate information to form a sound basis for directing the business and making effective decisions

(ii) Provide protection to the resources of the business against fraud, carelessness and inefficiency

(iii) Facilitate control of the business by furthering compliance with management decisions and policies

Internal Check and Internal Audit Internal check and internal audit differ from each other to a great extent in their scope and objective One should not be taken to be the substitute of the other The fundamental point is that one of the objects of internal audit is to "assure management that the system of internal check is effective in design and operation".

The *points of difference* between internal check and internal audit are as follows

(i) In case of internal check, the work of recording and checking of entries is carried on simultaneously with the help of judicious allocation of duties amongst the staff In case of internal audit only checking of the recorded entries is made, ensuring at the same time the effective operation of internal check amongst the staff

(ii) The internal check starts operating the moment a transaction is carried on till it is recorded in the books In case of internal audit it starts after the records have already been made in the books.

(iii) Internal audit is carried on by the staff specially assigned for this, whereas for internal check no special staff is appointed and every member of the staff is involved in it since one person's work is to be checked by another

(iv) The internal check is arranged with a view to *ensure minimisation* and prevention of errors and frauds of irregularities The internal audit is devised with a view to *detect* such frauds, errors and irregularities when they have already been committed and could not be prevented or detected by internal check arrangements

Features or Elements of good internal check system. An internal check system should have certain essential features if it has to be sound and effective An exhaustive list in this connection, however, cannot be prepared because of varying nature of business concerns Following elements are mentioned as a guideline

(i) There should be proper division of responsibilities of the members of staff The basic guiding principle for such division of work is that there should be segregation of responsibilities for carrying on the transactions and recording the same If the cashier, for example, is allowed to have approach to the Cash Book and is charged with the responsibility of recording the transactions in the Book, he may very easily misappropriate cash and conceal it by altering the

records Such separation of operating and accounting responsibilities is useful for all types of transactions.

(*ii*) The duties, instructions and procedures of each job should be stated in a written form to ensure that everybody understands his duty very clearly and, if need be, one may be able to fix definite responsibility on a particular person for the errors of frauds committed by him

(*iii*) If a large number of persons is employed in the concern, they must be kept in charge of some responsible officials

(*iv*) There should be internal transfers of the members of staff from time to time from one job or department to another As far as practicable, one should not be allowed to continue with the same work for long In particular, a Ledger-keeper should not be in charge of the Ledger for a long period. Those employees who do not take annual leave should be persuaded to take it so as to prevent them from having continuous control over the work entrusted to them and to verify their honesty during the period of their leave Strict supervision should be maintained over casual members of the staff In case overtime is given to some members, it should be properly controlled, and proper authority should be there to permit it

(*v*) Receipts and payments of cash should be controlled very carefully It is in this area that chances of frauds etc are greater. Therefore, the cashier must be under proper control It should be a practice to bank the receipts in tact everybody For petty cash transactions, the imprest system must be carefully followed.

(*vi*) For purchases made on credit, proper system should be introduced for placing orders and receiving goods Proper record should be maintained at the gate by the gate-keeper, in the store by the store-keeper and then by the accountant in the Purchases Book The goods should not be allowed out of the premises of the concern without proper permission Some responsible person should check the accounts of the debtors or the creditors from time to time. He should obtain from them the position of their accounts and then check it with that of the books maintained in his own concern At the same time, there should be proper supervision over making entries about bad debts, returns or allowances etc

(*vii*) The Self-Balancing Ledger should be used in the concern and the total accounts should be under the control of a responsible official. The use of automatic and mechanical devices *e g* cash registers, time-recording clocks, book-keeping and the calculating machines etc , should be made as far as possible and practicable.

(*viii*) In a large concern where personal contact between the management and the staff is not practical, efforts should be made to keep management well-informed Proper reporting to the management is also a necessary adjunct of a good internal check system.

(*ix*) However, the whole system should be devised in such a manner that it may be economical for the concern and at the same time may ensure greater efficiency on the whole. The internal check system must be carefully devised and duly regulated. It will not serve any purpose unless it is effectively enforced by the management.

Advantages The application of a good system of internal check in an organisation brings the following advantages —

(*i*) Where internal check is efficiently applied, it becomes *difficult for members of the staff to indulge into fraudulent practices*, the chances of successful frauds are remote as it involves independent and automatic checking of various transactions and the record thereof.

(*ii*) Any *dishonesty or irregularity* in the concern by members of the staff can be *detected* before they assume any complication.

(*iii*) A particular member of the staff may *be held responsible* for any irregularity carried on by him since respective duties of each are clearly defined.

(*iv*) The *chances of errors* creeping in the records are *reduced* to a minimum and they can be detected at an early stage.

(*v*) It puts *moral check* on members of the staff and enables them to learn honesty, straight forwardness and hard work.

(*vi*) It ensures *greater efficiency and speed* since arrangement of internal check is based on division of labour.

(*vii*) It may also *result into correct and complete records* of all the transactions and on easy balancing of the books which may help in prompt preparation of final accounts.

(*viii*) It *facilitates the work of the auditor* to a very great extent by enabling him to rely on test checking.

Limitations The system of internal check should be applied very cautiously as it has got the following limitations.

(*i*) It can be *applied in a relatively larger concern* as it may be uneconomical in a small concern. The principle of division of labour, on which the system is based, can be applied in case of a concern employing a larger number of workers.

(*ii*) The *auditor may not carry on a thorough and detailed checking* relying upon the soundness of internal check existing in the concern. It may amount to non-disclosure of certain important irregularity in the accounts affecting the final accounts vitally. However, if the auditor proceeds carefully this may be avoided.

(*iii*) The system of internal check is devised in such a manner that it ensures checking of errors and frauds only if there is no collusion between two or more employees of the concern. But if the employees join hands, they may keep the employer or the management

in dark and *may cause many irregularities defying any detection thereof* This groupism amongst the employees may not be healthy in the largest interest of the concern.

However, the above limitations may be removed if the employers or the management are careful in its effective application At the same time the auditor should also proceed very cautiously, reviewing the system carefully to avoid any confusion He should find out the loopholes of the system and carry on detailed checking in those directions in particular He should guard against the possibilities of collusion among the employees or even the officers which may upset even a well-designed system Fortunately, widespread collusion is a rare situation

INTERNAL CHECK AND THE AUDITOR

Operation of an efficient system of internal check helps an auditor to a great extent in the conduct of his work but it is wrong to think that it will reduce his responsibilities as well He may be relieved of a good deal of detailed checking which is automatically done in an effective system of internal check But he must make sure of its effectiveness and not rely blindly on test checking with full faith in the system of internal check

The extent to which an auditor may rely upon the system of internal check and limit the checking to certain tests would depend upon the degree of effectiveness of the operation of the system and the size of the business concern whose accounts he is auditing.

He should first consider carefully the system in force in the concern and find out its defects and weak points, if any, which may result into errors or frauds If, through his careful analysis of the system, he is satisfied that it is efficient and is being effectively and faithfully enforced, he may depend upon test checking of the transactions[1] He may restrict the routine work to certain periods only which he may select by way of tests If in the course of such test-checking no irregularity is found out, he may safely rely on it. But if the slightest suspicion arises, he should extend the scope of his checking and should check all the entries as far as possible It should, however, be noted that he should not carry on test checking of cash transactions, even if he finds that strong internal check system prevails.

On the other hand, if he finds that the system in force is not efficient or contains certain loopholes or is not being effectively enforced, the auditor should not rely upon it. He should try to check the records as exhaustively as possible, specially in those directions where there are weak links in the chain of the system. He must

1 See Dicksee's *Auditing*, p. 48.

satisfy himself by thorough checking that no advantage has been taken of its weaknesses.

In case of smaller business as managed by the proprietor himself, however, the division of labour is not possible and generally a book-keeper has full control over all the books of account Therefore segregation of accounting and operating responsibilities is not possible, though there may be direct control and supervision of management or client over the staff Under such circumstances, the auditor must undertake extensive and thorough checking of all the original records, vouchers and postings etc., as far as possible He should not rely much upon test-checking otherwise he may not be able to trace the irregularities

In a large business concern, the auditor may find, in general, the application of a good system of internal check It is not possible for an auditor to carry on the detailed checking of records of innumerable transactions of a big concern Therefore, he should try to check the effectiveness of the operation of internal check system and act accordingly, as mentioned above He would have to use his own discretion as to the extent of detailed checking He should satisfy himself as to the correctness of the records as far as possible But if the system is so faulty that it becomes difficult for him to get satisfaction as to the correctness of certain part of the records, he should mention it clearly in his report and should openly decline to share any consequential responsibility

He should bring to the notice of the authorities concerned the defects and weaknesses of the system and should suggest improvements In case his suggestions are not heeded to and implemented he should make it clear that he would not be responsible for any discrepancy on that account

GENERAL RULES FOR INTERNAL CHECK

In a well-organised business concern, the internal check should be enforced specially for cash receipts and payments, cash sales, petty cash transactions, purchases, sales, store and payment of wages etc Certain general rules may be laid down for the same, which should be adopted with certain modifications to suit the particular requirements of a concern. There cannot be any set and fixed rules which may be applied to every concern as conditions differ from concern to concern We give below some general rules for different transactions

1. CASH TRANSACTIONS

Numerous frauds are discovered by the auditiors in cash transactions alone and proper care should be taken in this respect General rules for arrangement of internal check for cash receipts cash payments, petty cash payments and cash sales are given below.

Cash Receipts. (*i*) The cashier should not be allowed to make records in the Ledger, or in any book of original entry On the other hand, the Ledger clerks should not be allowed to handle cash.

(*ii*) If possible, one person should be deputed for handling cash or cheques etc , and different person should maintain the Cash Book

(*iii*) In Cash Book, the receipt numbers should be given for the respective entries made therein

(*iv*) The customers may be requested to make payments by crossed cheques in the name of the firm and to accept only official receipts

(*v*) Only responsible persons should open all the letters and ensure special crossing with the mark "not negotiable" on all the cheques or postal orders received Before they are handed over to the cashier, either a list should be made of all such receipts or they should be entered in a cash diary which should be frequently or daily checked with the Cash Book

(*vi*) All the receipts in cash or cheques etc , should be banked in tact daily after being entered into the Cash Book Its periodical checking should be made by preparing the Bank Reconciliation Statement.

(*vii*) The receipt through cash sales should be checked and their records should also be examined There should be proper control over the amounts received from collection or discounting of the bills receivables.

(*viii*) Receipt books should be of a special form and receipts must be issued for all the remittances received The counterfoils of all the receipts issued should be properly maintained, *e g*, any alteration should bear the initial of the authorised person , no cancelled receipts should be destroyed , while signing the receipts, the counterfoil and original receipt should be properly compared Precautions should be taken for receipt book unused.

(*ix*) Statements of accounts sent to the debtors or collection made from them for overdue accounts should be examined by some authorised person other than the cashier.

Cash Payments. (*i*) All big payments should be made by cheques as a rule Petty expenditures may be made from petty cash. The cheques drawn for payment should be 'order cheques' and as far as practicable they should be crossed Only an authorised person should sign the cheque putting his initials on the corresponding counterfoils after verifying that the payment is in order.

(*ii*) From time to time efforts should be made to check up the cash balance and compare it with the Cash Book.

(*iii*) For petty cash expenses and payment of wages a proper system should be in force, as discussed later.

(*iv*) An official should check up the statement received from creditors and verify it with the invoices and Ledger accounts Only after such verification should the cheques be drawn in favour of the creditors For sanctioning the payment of special nature, only the partner, managing director or the principal should have the authority

(*v*) For all payments made, the vouchers should be obtained which should bear a consecutive number and filed As far as possible the cashier should not be allowed to do this.

(*vi*) The number of each voucher should be recorded in the Cash Book against the respective entry

(*vii*) Bank Reconciliation Statement should be prepared and it should be compared with the Cash Book by some authority other than the cashier

Petty Cash Payments (*i*) For all the petty cash transactions, the petty cashier and not the cashier should be made responsible

(*ii*) On the first day of each month, or as convenient, a cheque of reasonable amount should be drawn in favour of the petty cashier. No other receipts should be paid into petty cash Such receipts should pass through the cashier's hand and deposited in the bank

(*iii*) Records for such transactions should be made in the Petty Cash Book maintained on the Imprest System with analytical columns for different heads of expenditure.

(*iv*) As far as possible proper vouchers should be obtained for all payments made by the petty cashier In case a receipt cannot be obtained for certain types of payments, petty cash slips or dockets should be provided The petty cashier should fill these slips or dockets to make a list of such payments, which should be presented each day to some authorised person for initials All vouchers should be numbered consecutively and filed.

(*v*) The petty cash voucher numbers should be shown against the respective entries made in the Petty Cash Book.

(*vi*) As a rule, the employees should not be allowed to borrow from the petty cashier

(*vii*) The Petty Cash Book should be frequently examined and compared with the vouchers in detail by some responsible official or the cashier. He should also verify the cash balance with the petty cashier.

Cash Sales. They may consist of sales over the counter, the postal sales, and sales by travelling agents In a retail store the system of internal check for affecting control over the cash sales may be as follows.

Sales over the Counter (*i*) If the store is not quite large, the proprietor himself should have direct supervision over his employee who affects the sales and handles the cash as well

(*ii*) In case of a large retail store, a Cash Register should be maintained, as far as possible It should have secret total attachments for additions Other machines for tabulation work etc should also be maintained

(*iii*) For each section, counter or department, separate salesmen should be appointed who would look after their respective sections.

(*iv*) Each salesman should be provided with a Sales Memo Book with three sets of receipts consecutively numbered Different colour or number should be used for different sections so that they may be easily recognised

(*v*) When the sales are affected, each salesman attending the customers should enter details of goods sold with the amount to be charged in the Sales Memo Book and take out two carbon copies

(*vi*) The salesman should then show the Memo Book to some senior person who examines and verifies the details and the amount to be charged

(*vii*) Two copies of the Memo Book, including the original, should be handed over to the customer who then presents them to the cashier whose counter should be generally near the gate of the store

(*viii*) The cashier should check the two copies presented to him and receive the payment made to him He should put his initials on the copies of the receipts and put the stamp of 'paid' He should then hand over the original copy to the customer and file the carbon copy with him

(*ix*) The customer should collect his parcel of goods purchased from another counter on presentation of the receipt.

(*x*) The cashier should enter the details of the day's total sales in Cash Sales Sheet with the help of the Memos filed by him He should indicate the number of Memo also in that sheet and ascertain the total sales of the day

(*xi*) Eash salesman should also prepare a Summary Sheet with the help of the copy of Memo that remains with him.

(*xii*) With the help of Cash Sales Sheet and Summary Sheet provided by the cashier and the salesman respectively, the amount of total cash sales should be entered into the General Cash Book.

Postal Sales. (*i*) A separate V P.P Register should be maintained in which the particulars about the customer, quality of goods, price, date of despatch and amount received should be recorded.

(*ii*) Proper records should also be maintained about the goods returned by the customers and received through the post office.

(*iii*) The total amount received daily from postal sales should be recorded in the Cash Book

(*iv*) If some amount is received from the customer in advance that should also be entered into V P P Register properly

(*v*) The V P P Register should be frequently but irregularly examined by some responsible official It should also be compared with the Cash Book and the balance to be paid by the customers should be ascertained which should be confirmed through the correspondence with such customers.

Sales by Travelling Agents (*i*) The travelling agents or salesmen should not be allowed to collect the sale amounts from the customer directly as far as possible.

(*ii*) They should never be allowed to meet out any expenditure in connection with the sales out of sale amounts collected by them

(*iii*) If they themselves collect sale amounts from the customers, they should have clear instructions either to remit it in tact to the central office or deposit in the local bank, if any, in the name of the concern

(*iv*) They should be instructed to issue temporary receipt to the customers. But the confirmatory receipts should be issued by the office as soon as possible.

(*v*) The office should be kept informed about the balances which are overdue, stating reasons therefor Reminder to the customers should be sent by the office.

(*vi*) The office should prepare a statement about the debtors and should carry on correspondence with them and ascertain whether the balance indicated therein is correct or not.

(*vii*) Correspondence should also be made with those old customers from whom no orders have been received for long That would check whether any transactions has been fraudulently made by the travelling salesman without the knowledge of the office.

(*viii*) Efforts should be made to change the area of travelling agent or salesman from time to time.

(*ix*) The periodical statement submitted by the travelling agent should be properly examined by some responsible official.

(*x*) Cheques for expenditures incurred by them or their salaries or commission should be drawn in favour of the travelling agents or salesmen when they submit their periodical statements.

2 PURCHASES

(*i*) In a big concern, there should be a separate Buying Department to look into the affairs of purchases It should be made on the basis of authorised requisition by placing suitable orders with those offering goods at the cheapest possible rates and most suitable terms of payment

(*ii*) The Requisition Book should be maintained by each department, section or branch of the concern It should be duly filled when required The Requisition Notes with complete details should be submitted to the Buying Department It should be consecutively numbered and be filed when the order is already made on that basis

(*iii*) There should be a responsible official who alone should be authorised to sanction all the purchases to be made

(*iv*) An Order Book should be maintained with printed and numbered forms Order for all the purchases to be made should be obtained in writing from the responsible authority. Exception may be made for small sundry purchases required urgently

(*v*) All the orders should be given only on the printed forms of Order Book Two carbon copies should also be taken out The original should be sent to the supplier, one copy should be sent to the department or section requisitioning the goods and the other copy should be retained

(*vi*) On the order being accepted by the suppliers, a note may be sent to the respective department informing when the delivery is expected

(*vii*) The Goods Inwards Book should be maintained in which all the particulars about the goods received should be entered.

(*viii*) Invoices, when received, should be subject to scrutiny, specially for prices charged by some responsible official and be compared with the order given, If found correct, records should be made in the Purchases Book and it should then be consecutively numbered and filed

(*ix*) No invoice should be passed for payment unless the goods have been actually received according to the order placed Only responsible official should draw cheque for payment of invoice, but at the time of signing the cheque he must verify that only correct payment is made

(*x*) For the goods returned to the supplier, proper record should be maintained in the Purchases Returns Book. The suppliers should be approached for obtaining Credit Notes for goods returned or other allowances claimed, if any

(*xi*) Some responsible official should examine the Credit Notes and see that they are properly entered in the Purchases Returns Book.

3 SALES

(*i*) On receipt of the order it should be numbered and preserved in Orders Received Book with full particulars A confirmatory written order should be obtained for verbal orders

(*ii*) The despatch section should be given a copy of the order with necessary particulars It should see that the order is executed according to specifications

(*iii*) Outward Invoice should be made out on the execution of order, with a carbon duplicate copy A responsible official should check the invoice, particularly the rates charged and calculations made He should see that the terms and conditions in the order have been duly followed and there is no room for complaint by the buyer He should, then, put his initials on the invoice.

(*iv*) Copies of invoices should be consecutively numbered Number of an order should be put against the corresponding invoice and vice-versa

(*v*) With the help of the copy of invoices, which should be duly filed, entries should be made in the Sales Day Book.

(*vi*) On despatch of the goods, records should be made in the Goods Outwards Book.

(*vii*) Entries should be made in Goods Inwards Book for all the goods returned by the customers For that Credit Note should be prepared taking out a carbon copy It should be duly checked and initialled by the responsible official

(*viii*) With the help of the copies of Credit Notes, records should be made in the Sales Returns Book The Credit Notes should be filed. The number of Credit Notes should be entered against the corresponding entry in the Sales Returns Book and vice-versa

WAGES

The system of internal check for wages should be devised in a careful and planned way, specially in manufacturing concerns There are greater possibilities of frauds in a concern employing a large number of workers. Efforts should be made to prevent them with the help of some suitable arrangement of internal check which should be revised from time to time in the light of experience gained. It should be actively enforced and supervised by some responsible official The objects are to avoid inclusion of dummy workers in the list, incorrect time or piecework records, fraudulent manipulation of wage-sheet and misappropriation of money etc To minimise each risks of fraud the following outline of internal check for wages is given

Maintenance of Wage Records. *Attendance records* The time spent by each worker should be correctly recorded and for this the following methods are in practice.

(i) The *time recording clock* is placed at the gate under the charge of a time-keeper As the worker enters the gate he inserts his time card into the clock which records the time on it It is again recorded when the worker leaves the factory

(ii) In case the time recording clock is not maintained, the workers are given a *brass token* bearing their numbers At the gate a time-board is maintained on which each worker hangs his token as he enters the factory The time-keeper is, thus, able to record the time of workers entering the factory. The time-keeper should be vigilant and see that no worker hangs the token of others who are late or absent

(iii) The other method is to issue *attendance cards* to every worker with his name, number, department, rate of wages etc The worker puts the card into a box provided at the gate as he enters. The time-keeper maintains the records in the attendance register from such cards

Time Records For the workers, who are to be paid time wage, *time cards* should be used. Each worker is provided with a time card bearing his name and number He should write the time of his arrival and departure from the factory, the jobs for which he is engaged and the department in which he works. The foreman in charge should initial the entries on the card At the week-end the cards should be collected from the workers and sent to the wage office.

Piece-Work Records Where the workers are paid on piece-wage system, each worker should be provided with a *job card* or Piece-Work Return Form bearing his name, job number, nature of work, and the rate at which the wages will be paid When the job is given out it is entered on the Card. On completion, it is checked and this Card is initialled by the piece-work reviewer

Overtime Records Overtime should be sanctioned in advance by some authority who should issue overtime slips Such slips should bear the name and number of the worker, overtime put in and the job or the department in which he is engaged Such slips should be issued, filled and initialled by some authority At the week-end such slips should be sent to the time-keeper who then forwards them to the wage office

Pass-out Records The workers should not be allowed to leave the factory before the scheduled time If they have to go out of the factory, they should take written permission For this a Pass-out Slip is issued to the worker by some authority who initials it and mentions the purpose of his going out. Such slips are handed over to the gate-keeper The wage office should also be given a copy of such slips While preparing the wage-sheet, the slips with the wage office should be checked with the corresponding slips initialled by

the gate-keeper In case the worker leaves the factory before time on his own account, it should be properly accounted

Preparation of Wages Sheets Either Wages Books or loose Wages Sheets should be maintained In case of a large factory, it would be advisable to keep loose Wages Sheets so that the work may be distributed amongst various clerks For time-workers and piece-workers separate Wages Sheets or Books should be used

In the Wages Sheets or Books all essential particulars should be entered They should have *columns* for (1) name, (2) number of each worker, (3) time worked, (4) details of work, (5) rate, (6) amount of wages, (7) bonus, (8) overtime, (9) gross amounts payable, (10) deductions, and (11) net amount payable.

The Wages Sheets or Books should not be prepared by one clerk alone A set of clerks should compare the records at the gate and the Wages Office and enquire about the differences, if any.

Another clerk or a set of clerks should enter on the Wages Sheet or Books, the name of workers, their numbers, rates of wages, number of hours worked and particulars of deductions, if any, to be made The net wages to be paid to each worker should be calculated by separate clerk or clerks The Wages Sheets should be cast by another clerk All the calculations should also be checked by a separate clerk Each clerk who took part in the preparation of Wages States should initial it for the works he performed The Works Manager or other responsible official should countersign it as a whole.

Payment of Wages. It is essential that the wages should not be paid by a person who took part in the preparation of Wages Sheets. For instance, the Cashier should not be associated with the preparation of Wages Sheets. One cheque should be drawn for the exact amount of wages to be paid Each worker should be asked to receive his wages personally in the presence of his foreman to identify him The presence of Works Manager or some other responsible officials also may ensure check against frauds. Care should be taken that no payment is made to someone on behalf of a worker who is absent. Some special arrangement should be made for payment to the absentees Advances to the workmen should be discouraged and if it becomes unavoidable, they should be given through the petty cashier Later on, they should be deducted from the wages of the respective workers.

If *casual workers* are also employed in the factory, a separate record should be maintained about them Daily records about their names, rates of wages, work done and total wages due should be maintained. They should be paid daily or with the regular workers, the latter being preferable. Their daily records should be checked from time to time by a senior responsible official.

5. STORES

In a big industrial concern, a large store of merchandise has to be maintained There should be proper control over them to safeguard against possibilities of theft A suitable system of internal check should be devised for stores with a view to ensure correct records, reduce waste and prevent thefts of merchandise

The following general rules may be followed to ensure effective control over stores

(*i*) The store room should be located at such a place that anyone who enters or leaves it should pass by some responsible official. There should be only one door and admission in the room should be duly restricted.

(*ii*) On arrival of goods, they should be properly recorded by the store-keeper on Goods Received Sheets, numbered serially They should be prepared in triplicate, one copy to be sent to the Accounts Department, other to the Buying Department and the third copy to be retained in the store. It is advisable to separate all the clerical workers from the stores department who record the materials and stores received in or sent out to safeguard further checking of materials received by or despatched from the stores

(*iii*) All the items in the stores should bear a reference number and properly arranged on racks and bins at a pre-determined place.

(*iv*) Bin Cards should be used in the stores which should be hung outside each bin or rack Bin Cards should be filled in by store-keepers who should have no access to Stores Ledgers Bin Cards should contain description of items received, quantity taken out and balance in hand Store Ledgers should be written from the Stores Received Sheets and Stores Issued Book and should be maintained by person independent of Stores Office

(*v*) No item from the stores should be issued to any person without formal requisition from some authority For this Stores Issued Requisition should be used duly signed by some authority Only authorised person should be allowed to remove articles from the stores according to the requisition For the materials or stores returned from the job or the departments Material Returned Notes should be written and properly accounted for Likewise, Material Transfer Notes should be used for the materials transferred from one job or department to another For this, no record is required in the stores department

(*vi*) The gate-keeper should be instructed not to allow any material out of the factory without necessary permit from the store-keeper A Gate Book may be maintained in which the gate-keeper should record all the goods received in or sent out of the factory

(*vii*) After the issue of materials from the stores, the Stores Issue Requisition should be sent to the Stores Accounts Section for proper records there

(*viii*) Stock-taking, if possible, should be carried on throughout the year At irregular intervals inspection of the stores should be made by some responsible official He should check at random the quantity of materials on the rack or bin, with the records of Bin Cards or Store Ledgers.

QUESTIONS

1. What is internal control ? Distinguish clearly between the administrative and accounting control.

2 What is internal check ? How does it differ from the internal audit ?

3. Define internal check and point out its objects.

4 What is internal check ? Explain it briefly and describe the essential features or elements of a good internal check system

5 Distinguish clearly between the internal check and describe its advantages and disadvantages.

6. You have been appointed an auditor of a company To what extent you would rely upon the internal check system prevalent there.

7 What is internal check ? How does an auditor stand in relation thereto ?

8. Explain the terms 'Internal Control', 'Internal Audit' and 'Internal Check' clearly with the help of suitable examples

9 Describe a system of internal check suitable for the wage payments in a large manufacturing concern

10 Describe a suitable internal check system for the stores of a manufacturing concern.

11 You have been appointed a manager of a big retail store How would you devise a internal check system for the cash receipts and payments of the store ?

12. Describe a suitable internal check system for purchases and sales.

13. Describe internal check system for cash transactions of a super market

14 Discuss internal check system for postal sales and sales by the travelling agents

15. "Auditor should first review the internal check system prevalent in the concern and then proceed to audit " Discuss it and explain the relation of an auditor in this regard

6

Routine Checking, Vouching and Materiality

ROUTINE CHECKING

Routine checking means checking of arithmetical accuracy of books of original entry and Ledgers with a view to detect clerical errors and frauds of a very simple nature In general, it includes checking of the following

(i) Casts, subcasts, carry forwards, extensions and other calculations in the books of original entry ,

(ii) Posting into the Ledgers , and

(iii) Ledger accounts to see their casts, balancing, carrying down of the balances and their transfer on to the Trial Balance

The *main objects* of routine checking are (i) to verify the arithmetical accuracy of the entries made in the books of account with a view to unearth errors or frauds of simple nature , (ii) to verify that postings from journal to ledger have been made to the correct accounts and balancing of these accounts have been correctly done , and (iii) to ensure that after the routine checking is over the figures have not been erased or altered This is usually done by use of special types of 'ticks' for checking.

Advantages

(i) If helps in checking the arithmetical accuracy of books of original entry ,

(ii) If helps in detecting minor frauds and less complicated errors.

(iii) Is helps in finding out whether all the postings have been made from Journal to Ledger and other subsidiary books

(iv) It forms the basis for final and thorough checking of accounts and ensures reliability of final accounts and statement to some extent.

(*v*) It ensures that no alteration or erasures have been made after routine checking has been undertaken, as special types of ticks are used for it

(*vi*) It may be undertaken easily, as it involves checking of elementary nature

Limitations

(*i*) The checking of castings and postings etc is more or less of a mechanical nature It may turn out to be monotonous for those who are entrusted with this job But it has to be carried out intelligently with care and caution as it is the very foundation upon which the final results of audit depend (*ii*) It may reveal only clerical errors and frauds of a very simple nature It does not reveal the errors of principles and well-designed frauds (*iii*) This job is usually allotted to the junior clerks who are likely to attach less importance to it, but care should be taken that it is carried on with efficiency

The extent to which the auditor will take up routine checking depends upon the volume of business and internal checks, if any In a small concern with practically no internal check system, the auditor should check up the whole of the castings and postings In a large concern, with an efficient system of internal check, it is not necessary to check the casting from the beginning to the end The auditor carries on test checks at his own discretion after careful study of the situation

Test checking In a large business undertaking, it is rather impracticable for an auditor to check all of the numerous transactions It is not only impractical from economic point of view but unnecessary as well, since management today ensures the accuracy of accounts to a great extent through effective application of internal control[1] *The auditor makes use of the test checks, which implies limiting his examination of every transaction entered by his client in the books to certain tests of the internal control and the data in the financial statements It involves a more intensive checking of a limited number of transactions selected on random basis from the total accounting data as against a detailed checking of all the transactions*

The justification for test checks lies on the theory of probability which states, in effect, that a sample selected from a series of items will tend to show the same characteristics present in the full series of items, which is commonly referred to as the "population" or "universe" Greater the size of the sample, greater the chances of presenting the characteristics of the population

1 L R Dicksee says that 'The theoretical responsibility of the auditor extends ultimately to every entry in the books of account but it does not follow that it is either necessary or possible to examine every entry in detail" *Auditing*, p 47

No hard and fast rules can be laid down with regard to the selection of sample for test checking, as the conditions presented in each case are not likely to be duplicated The extent of his reliance on it should be determined by the degree of internal control inherent in the client's organisation and such factors as materiality of amounts, relative risks of omission and the reliability of the evidence consulted Thus, the auditor will weigh each of these factors carefully and decide the extent of tests to be made on the basis of his professional skill developed through experience and interchange of ideas with other members of his profession

Great care should be taken while selecting items for inclusion in the sample The best method is to have random selection Stratified sampling may be used—say, to examine all disbursements of Rs 1,000 The sample should include the work of each clerk in the business concern and cover items from all the books *It is advisable not to apply test check to Cash Book which should be checked in detail*

In test checking, each item included in the sample must be very carefully examined or reviewed as the sample selected may reveal only a single spurious item or transaction, even though several may be presented in the records Carelessness in reviewing even a single item may, thus, fail to detect existing frauds or irregularities in accounts.

The auditor should carry on further detailed investigation if he comes across just one error or questionable item or if the test check reveals that proper accounting procedure is not followed. Any indication about the existence of frauds should make him alert and he should not proceed ahead without settling the matter with the client The auditor should also bear in mind that the curtailment of his work due to test checks will not in any way lessen his responsibility, and thus, he must not lose sight of the risks involved

Precautions before applying Test Checking An auditor should be very careful while applying test checking, as he cannot take a plea that he did not check certain records, as he undertook only test checking Therefore, he must take the following precautions before he applies test checking for audit :

(*i*) The auditor must review the system of internal check, internal audit or internal control thoroughly If he finds that the internal control system is either defective or ineffective, he should not apply test checking

(*ii*) He should apply test checking if he finds that the transactions to be checked are homogenous in nature He should not, in general, adopt test checking if the transactions are dissimilar in nature

(*iii*) The sample of records, selected for test checking, should be taken on random basis and should be, as far as possible, representative in character

(*iv*) There should be no element of bias or arbitrariness in the selection of sample

(*v*) In case the auditor finds that there is a change in the personnel or documents-flow, the sample selected for the test checking should include fairly large number of transactions of the period, both before and after the change

(*vi*) The auditor must always review the results of test checking with a view to find whether there is any further scope of checking records, not checked so far The nature of errors detected throughout test checks may reveal this, if they are probed carefully

Transactions not suitable for Test Checking Following are the transactions which are not suitable for test checking, and therefore, the auditor should examine them in detail

(*i*) Opening and closing entries

(*ii*) Bank reconciliation statement

(*iii*) Matters involving estimation as well as computation, *e g.*, depreciation, royalty etc

(*iv*) Presentation and disclosure of information in the profit and loss account and the balance sheet

(*v*) Items which are material or which have material effect on disclosure in a financial statement

(*vi*) Transactions which may be small in number which may be important

(*vii*) Transactions which are recognised by law to be looked into by the auditor carefully, e g , managerial remuneration and purchase transactions etc

(*viii*) In case of seasonal industry, the auditor should not resort to test checking on annual basis

(*ix*) Transactions of non-recurring nature or exceptional transactions need not be test checked

Advantages Test checking offers following main advantages .

(*i*) It helps auditor in completing the audit work in a short period with lesser strains on him

(*ii*) He is able to complete the audit of accounts of many concerns within stipulated time.

(*iii*) It saves time and energy of auditor from the detailed audit of a large mass of repetitive data, and thus, it enables him to devote more time and energy on important matters

(*iv*) It ensures the accuracy of books to a large extent

(*v*) It keeps the client's staff alert as they know that any entry recorded by them may be taken for checking by the auditor

Limitations Inspite of the advantages, mentioned above, it suffers from following limitations also

(*i*) It may result into failure to detect errors or frauds as the samples selected for test checking may not include them

(*ii*) There is a possibility that the auditor may not be able to get the correct position of financial state of affairs of the concern, if he applies test checking With the result, his report may not be correct and duly reliable

(*iii*) It also increases the responsibility of an auditor to a great extent, as he may be held liable for negligence in case of subsequent detection of frauds etc

Audit Procedure. There is no standard procedure for conducting the audit of various concerns Each auditor follows his own method according to his skill and experience, nature of the concern and the way in which accounts are maintained and checked internally He must be guided by the exigencies of the situation which he comes across He has to combine thorough knowledge of principles and procedures, sound judgment and an open mind However, there is a common procedure with regard to the use of ticks, calling backs etc

An auditor should devise a code of distinctive *ticks* for different types of transactions There should be ticks of different colours for posting, additions, vouching, carry forwards, controls, cancellations etc Different colours of pencils or ink should be used for each period of audit and for different concerns Special ticks should be used for figures erased out are cancelled The code of ticks should be kept secret and should not be disclosed to the client's clerks If the system of ticking is used logically, it may be of great help to the auditor

He should adopt the *principle of simultaneity* and efforts should be made to check all the related transactions at one time while the books are under his control He should see that checking of the work of each section is completed before the books and vouchers are returned

No erasures should be allowed and all the wrong or bad figures should be scored out and correct figures entered in their place In case any adjustment is necessary, it should be made through passing

entries in the Journal. He should not accept pencil figures If on his subsequent visit he finds alteration in the figures, he should investigate the matter thoroughly and carefully If he is asked to audit the books before the accounts are balanced, he should not accept it as a rule *It is not his duty to balance the books*[1]

The clerks engaged in calling back the figures should speak very clearly and avoid slovenly or excessively fast calling out the figures. The calling back carelessly may cause trouble and arouse confusion Figures like ninety or nineteen should be clearly and carefully called back

The auditor should try to make notes of material figures or erased or altered figures in his Audit Note Books It will be of great use to him in future when any confusion or dispute arises He should exercise his own discretion as to what he should note down and what not

He should undertake *surprise checks* during the course of his audit It has been recommended by the Council of Institute of Chartered Accountants of India, in November 1975, that surprise checks should be made "by a desirable part of each audit." Such checks should be undertaken specially to verify cash investments, statutory books, stores etc The frequency of such checks would depend upon the circumstances prevailing in each case However, it has been suggested by the Council that it should be "at least once in the course of an audit" The auditor must realise its importance fully and must not simply rule it out as an outmoded technique, not necessary today In fact, it would help him in finding out weaknesses, if any, imposing moral check on the staff It would definitely improve the effectiveness of audit, on the whole.

VOUCHING

Vouching is a potent tool in the hands of auditors to ascertain the accuracy of various transactions entered in the books of account It is the essence of auditing *It means the examination of the transactions with sufficient underlying evidences to satisfy an auditor about the validity, accuracy, authority and authenticity of the records entered in the books of account* To substantiate an entry in the book, the auditor has to examine the supporting documentary evidences such as vouchers, receipts, invoices, minutes, contracts, correspondence etc

According to *Taylor and Perry*, vouching "may be defined as the examination of the evidence offered in substantiation of the entries in the books, including in such examination the proof, so far

1 Spicer and Pegler, op cit p 25

as possible, that no entries have been omitted from the books."[1]

According to *F R M de Paula*, "Vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of receipts with the transactions of a business, together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized and are correctly recorded in the books" In this definition, de Paula suggests clearly that an auditor has to satisfy himself, with the help of sufficiently valid evidences, with regard to the records of the transactions in the concern.

In the words of *Joseph Lancaster*, "It is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries This, however, is quite wrong, for vouching comprises such an examination of the ledger entries as will satisfy the auditor not only that the entry is supported by documentary evidence but it has been properly made upon the books" He has very rightly summed up the distinction between the technical and commonly understood meaning of the vouching He has made the concept and object of vouching quite clear

Thus, on the analysis of the above definitions of vouching, we come to know that the vouching has following main aspects:

(a) It involves collection of vouchers and related evidences ;

(b) It involves evaluating the collected evidences and vouchers,

(c) It refers to examination of the vouchers or evidences in such a manner that the auditor may satisfy himself with regard to the correctness and authenticity of the records of transactions,

(d) It implies finding out whether entries have been properly made in the books of account or not

(e) It involves finding out that there is no omission of any records; and

(f) It also refers to checking the entries with a view to find out that transactions which are not related to the concern have not been recorded in books of account

(g) It forms the basis for final conclusion to be drawn by the auditor

Mautz and Sharaf have listed following *five steps* in this connection[2] They are.

1 Recognition of the proposition to be proved

1. *Principles of Auditing*, p 86
2 Mautz, R K and Hussein, A Sharaf, *op. cit.*, p 103.

2 Evaluation of the propositions in terms of materiality or significance.

3. Collection of evidence within the given limits of time and cost

4 Evaluation of the evidence obtained as valid or not valid

5 Formulation of judgment as to the proposition at issue

IMPORTANCE

Vouching has been said to be the 'essence' or 'backbone' of auditing, as it is one of the most potent tools in the hands of auditors.

It has been rightly stated that "sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination "[1]

On the face, the entries appear to be innocent Unless the auditor goes behind the books of account and traces the source of entries, he cannot ascertain the truth For example, an entry in the book shows that payment has been made to Ram But the fact may be that fictitious payment might have been shown in the accounts simply to misappropriate the money Or payment might be real, but might not be on account of the business or the particular year concerned This can be found out only if related vouchers are examined very carefully Thus, it is not only the arithmetical accuracy of the books which is the concern of the auditor but he has to go beyond it and satisfy himself that the entries are actually correct and rel[illegible] concerned and the year under audit With the help [illegible] the auditor may find out such entries which are contrary to facts Various errors and clever frauds may be unearthed by vouching if it is carried out with care and intelligence The auditor may also ascertain, as far as possible, that all the transactions related to the business concerned have been recorded in the books of account and that there is no omission

Vouching has a wider implication and includes routine checking Both are, however, interlinked and one is incomplete without the other Both are necessary to ascertain the accuracy of entries made in the books of account

'Success of audit depends to a great extent upon the vouching The auditor has to apply his experience, width of knowledge of accountancy, critical faculty, keen observation and common sense to get the best result out of it If carried on mechanically, it would not be of great use It has been rightly called the backbone of auditing.

1 *Statement of Auditing Standards*, American Institute of Certified Public Accountants, New York, 1973, p 5

VOUCHING IN DEPTH

Vouching in depth implies examination of accounting records in depth It is a technique which combines in itself the elements of sampling and procedural check This is undertaken with a view to check the incidence of frauds and errors in the accounting records Adoption of such a system of checking becomes essential in large concerns, where detailed examination of all the records is not possible.

This technique of vouching in depth involves selection of a sample of transactions from one area of accounting and tracing them from the beginning to the end or *vice-versa* In this process, it has also to be examined whether the laid down procedures have been properly followed or not Such an examination in depth may involve detailed checking of records of a particular period or periods spread over a longer period of time However, it is not necessary to increase the size of sample while extending the period of examination The number of items covered may be changed according to the needs or experience gathered in the course of examination However, the procedure followed in this connection may be quite flexible enough to suit the requirements of the client's concern

Sometimes, the expression vouching 'in depth' is also used in a limited sense only It then implies checking of the vouchers by reference to the same being checked with the entries in the books of account, underlying papers and records, appropriate, approval of the voucher and acknowledgement of the payment in case the voucher is in regard to a payment.

Evidence or Vouchers In vouching, an auditor's purpose is to gain contact with sufficient underlying evidence which need mention here An evidence may be physical or documentary The documentary evidence is commonly known as voucher *A voucher may be defined as a written documentary evidence in support of a claim or other statement of facts or transaction in the books of account* In a narrow sense, or as commonly understood, it is evidence of the payment of cash But in modern accounting usages it includes "the evidence of the reason for which the cash is disbursed, apart from the evidence of actual disbursement".[1] We find vouchers in many forms It may be a receipt, a contract, minutes, invoices, correspondence, Bought Notes, Sold Notes, Wages Book etc

While examining the vouchers, the auditor should have *two main considerations* in mind, *Firstly*, how much evidence should be obtained in support of a transaction, and *secondly*, to what extent

1. Bell and Johns, *Auditing* p 55

he should rely upon the available evidence. The quantity of evidence to be secured by him will depend upon the degree of internal control applicable in the client's organisation, the materiality of the relative size of figures and the relative risks involved in particular items He should realise the need for examining additional evidence in case of items subject to normal than moral risk

Reliability of the vouchers available to him depends upon the sources of documents as follows

(*i*) Vouchers which have been prepared by the third party and sent directly to the auditor are ordinarly the most reliable.

(*ii*) Vouchers which have been prepared by third party but are in the possession of the client have a lower degree of reliability They may be fictitious or altered by the client's staff, but they are not valueless as evidence

(*iii*) Vouchers which originate within the client's organisation are the least reliable There are chances of falsifying the vouchers deliberately to conceal any fraud or manipulation. The employees may get a chance to prepare a voucher giving false evidence The degree of reliability of such vouchers increases if good internal control exists about the preparation and use of documents.

The auditor, thus, has to be very careful in examining each voucher and should pay special attention to the following points.

(1) It is in the name of the client.

(2) Its date relates to the period under audit.

(3) The amount entered therein is the correct one

(4) Its particulars correspond to those of the records of transsaction entered in the books

(5) It is properly stamped

(6) It has been passed by a responsible officer

(7) It has been accepted by him in support of a previous transaction

(8) In general, it appears to be genuine on its face

The auditor should note, while examining the vouchers, whether certain items require further evidence such as Partnership Deed, Contract, Minute Book, Articles of Association etc

The auditor should instruct that all the vouchers should be properly filed and consecutively numbered. All the vouchers relating

to a particular book should be produced at one and the same time He should cancel each voucher with the help of a rubber stamp or a special tick as soon as a voucher is passed, so that it may not be reproduced

Sometimes, he finds some vouchers missing In such cases, he must prepare a list of all such missing vouchers Enquiries must be made about them with the clients and duplicates for them should be obtained If he feels necessary, he should examine other related evidence to substantiate such duplicate vouchers

CONCEPT OF MATERIALITY

The principle of materiality is and has always been fundamental to the whole process of accounting An auditor has also to be quite concerned with regard to the concept of materiality. In fact, he has to analyse and take decisions regarding various items whether they are material or not during the course of an audit This would require thorough knowledge, competence and experience on his part In case, he finds that an item is quite material in nature, he would have to give careful consideration to its checking and would call for more evidences in support In fact, he would have to undertake an 'audit in depth' to satisfy himself regarding such material item.

It is not very easy to define the term 'material', though it has been used very often in the statutes and other books Moreover, its meaning would differ in different circumstances. The dictionary meaning of the term is "of serious importance, esp of legal importance" [1] It implies that any item or transaction is material, if it is of serious importance under a given condition or auditing situation It would be for an auditor to apply his own discretion to decide whether an item is of serious importance or not in the circumstance of a particular case If the circumstances change, he would have to think afresh

In an accounting sense, an item may be taken to be material, if its non disclosure, mis-statement or omission would be likely to distort the view given by the accounts or other statements under consideration It may be pointed out that arithmetical accuracy, although fundamentally important in accounting, is not itself sufficient to satisfy the legal requirements That is why the widest possible appreciation must be made and the consideration of materiality must be kept in view.

Thus, every auditor must decide about the items to be material in the given situation and must include those items in his audit programme carefully so that they may be examined properly and

1 See Chamber's Twentieth Century Dictionary, 1964

in detail If he is not careful about them, he may be held liable for the same

In the Companies Act, 1956, the word 'material' has been used on several occasions. The Schedule VI attached to the Act requires that the financial statements should disclose all 'material items' so as to give true and fair view of the financial state of affairs of the company Part II of Schedule VI requires that the profit and loss account should disclose every 'material feature' What is material, however, has been left to the discretion of the accountant and auditor Any criteria to be adopted for the decision about the materiality, however, should be firmly based upon a real understanding of the full significance of the words 'true and fair' as introduced for the first time in the Companies Act, 1956 in place of words 'true and correct'

Similarly, the Second Schedule to the Chartered Accountants Act, 1949 also refers to it Clauses 5, 6, 8 and 9 of Part I of this Schedule refers to 'mater al fact', 'material mis-statement', 'material exceptions, and 'material departure from the generally accepted procedure of audit' etc

Its importance has been underlined in the *Statement on Auditing Practice* issued by the Institute of Chartered Accountants of India It has been stated in it that the recommendations contained in it would "apply primarily to items which are material and significant in relation to the affairs of a company Items of little or no significance may be dealt with as may be found expedient, as it is neither desirable nor necessary that members should devote their time and energies in the pursuit of matters of a trivial nature However, freedom to deal expediently with non-material items should not extend to a group of items whose cumulative effect on the accounts may be material and significant"

CRITERIA FOR JUDGING MATERIALITY

It is very difficult to lay down any general criteria or guidelines for determining what is material and what is not material However, certain generalisations may be made in this connection which would help an auditor to take decisions in this respect

(i) The question of materiality can arise in relation to (a) disclosure, including manner of disclosure, (b) correction of errors or omission, (c) methods of computation etc

(ii) Materiality has to be seen and judged only in relative context, and not in absolute term For instance, Rs 1,000 may be a material amount in case of a smaller concern whereas it may not be so in case of a large concern. In the latter case, even Rs. 10,000 may not be material

(iii) Items of small amount are not necessarily insignificant, especially where they might have been expected to be larger Even a small amount may become material if its disclosure is essential statutorily For instance, payment to the directors as sitting fee has to be disclosed precisely and separately

(iv) Several individually insignificant items might represent a material amount in total That is why, it is necessary to see as to what is the impact of an item on the total of the category of items to which it belongs For instance, amount received as dividend would be material if it affects total amount of income from investment considerably

(v) Care should be exercised before offsetting items of opposite effect where each on its own might have been referred as material, *e.g*, a non-recurring loss against a profit arising from a change in the basis of accounting

(vi) While judging the materiality, the impact of the item concerned on the profit and loss account and the balance sheet also should be duly taken into account If the item is such that it would affect profit or loss significantly that should be taken to be material Similarly, if an item affects the financial position of the concern significantly that should also be taken to be a material one.

(vii) Sometimes, the percentage comparisons may be made to judge the materiality of an item The Companies Act, 1956 itself has indicated it as an indicator of materiality For instance, Part II of Schedule VI to the Act requires that any item exceeding 1 per cent of the total revenue of the company or Rs 5,000, whicheve, is higher, shall be shown as a separate and distinct item under an appropriate account head in the profit and loss account and shall not be combined with any other item to be shown under miscellaneous expenses.

(viii) Comparison with the corresponding figure in the previous years may also serve to be useful indicator of materiality For instance, if the amount of an item is not significant this year but it was quite significant in the previous year, then that item would become material this year

(ix) While judging the materiality, it would also be seen whether the items are capable of precise and accurate determination or not If it is so, even a small error in the same would become material. But if the amount of a particular item is to be compiled on the basis of estimation, a small error would not be material For instance, depreciation cannot be calculated correctly or precisely but can be simply estimated. Therefore, an excess provision of the depreciation by Rs 100 or 200 would not be material

QUESTIONS

1 What do you understand by the term 'routine checking'? Discuss its objects, advantages and limitations

2. What is test checking? What precautions should be taken before applying test checking?

3 Define test checking and describe the transactions which are not suitable for test checking

4 What is test checking? Discuss its advantages and limitations

5 Define vouching What precautions should be taken by the auditor while examining the vouchers?

6 Explain the term 'vouching' and discuss its importance

7 "Vouching is an essence of auditing." Explain this statement with suitable examples

8 Explain the concept of 'materiality' What are the criteria for judging the materiality

9. Write short notes on the following

(a) Vouching in depth

(b) Audit procedure

(c) Evidence or vouchers.

(d) Reliability of vouchers

(e) Surprise checks by auditor

7

Vouching of Cash Transactions

Cash transactions take place almost daily in every business concern There may be receipts of cash from various sources such as from debtors, sales or investments etc, similarly payments of cash have to be made to creditors or for purchases or establishment expenses etc. Such receipts and payments may be made either in cash or by cheque Their records are found in Cash Book and Bank Pass Book For petty expenditures Petty Cash Book may be maintained Vouching of cash transactions is important from the auditor's point of view because it is the cash which prompts anybody to be dishonest and it is his duty to guard against such dishonest and fraudulent practices For this he has to vouch the Cash Book, Petty Cash Book and the Bank Cash Book

CASH BOOK

Cash Book is of great importance in every business concern It contains records of all cash transactions The auditor should vouch it intelligently and carefully as there are greater chances of fraudulent manipulations in this book

He should enquire the system of internal check prevailing for the receipt and payment of cash and note down its weak points He should ascertain whether a Diary of Cash Receipts is maintained or a Rough Cash Book has been in use In each case he should check the entries in Cash Book from the Diary of Cash Book or Rough Cash Book exhaustively to detect any discrepancy therein He should also check the Bank Pass Book with the entries in the Cash Book A Bank Reconciliation Statement should be prepared and balances of both the books should be verified We discuss below the vouching of items of receipt and payment sides of the Cash Book separately

(A) Receipt Side of Cash Book

The vouching of receipts of cash is more difficult than that of its payment as the auditor gets only indirect and less reliable evidences in case of the former For example, if some amount is received from a debtor, the receipt has to be issued from the office itself The office will maintain only a copy of such receipt Such copies may

be made different that the original which will not be available to the auditor for vouching If a suitable and sound system of acknowledgment of receipts is not prevalent, there are greater chances of frauds The method of issuing receipts to the customers should be checked The client should be advised to keep a carbon copy book of receipts rather than a counterfoil book in which the wrong amount may be entered To prevent this the auditor should advise the client to take the following precautions

(i) A responsible official should keep all the counterfoil receipt books under lock and key and issue them cautiously

(ii) All the receipts in a book should be consecutively numbered and no number should be missing

(iii) Instructions should be given that no spoilt receipt is destroyed and should be kept attached to the counterfoil. It should be initialled as cancelled by some official

Various items of cash receipts may be vouched as follows

Receipts from debtors. The documentary evidences available to the auditor for vuoching the receipts from debtors are the copies or counterfoils of the Receipt Books He should vouch counterfoil receipts with entries in the Cash Book thoroughly In a large business he may vouch a certain but substantial number of counterfoils with the Cash Book, as he cannot check all the counterfoils receipts He should see that the dates on the counterfoils correspond with those in the Cash Book However, he should ensure that the various precautions with regard to counterfoils, as mentioned above, are adhered to

He should pay special attention to the discounts allowed, allowances and bad debts The discount rates should never be allowed to exceed the usual percentage If any special discount has been given it should be noted down and verified He should make thorough enquiry, if he suspects fictitious discount which may be entered to conceal some fraud

He should check the debtors' Ledger intelligently to find out any outstanding debts He must seek explanation for the same Since mere agreement of counterfoils with Cash Book is no conclusive proof of its accuracy, the auditor should, as far as desirable, correspond with the debtors and ascertain the correct position Any discrepancy revealed should be thoroughly enquired into

Cash Sales For vouching cash sales, the auditor has to depend upon the effectiveness of the internal check system, since the opportunities for fraud in this case are many He must check all the available evidences exhaustively He should check substantially the carbon duplicates of cash sales Memo's with the cash sales summaries and the cashier's abstracts He should check the daily totals of receiving cashier's Cash Book with the General Cash Book In case

the cash registers are in use in the concern, they ensure greater accuract and the auditor should check the daily totals recorded in the Cash Book with the till rolls

Interests and Dividends, i e, incomes from investments The auditor should examine the Investment Ledger usually maintained in the business concerns He should then see that all the interests and dividends have been received at due dates and they have been duly accounted for If the rates of interest and dividends are fixed the auditor should make calculations and check them He should also vouch the Cash Book with the counterfoils of dividend warrants In case the collection of interest or dividend is made through the bank, the Pass Book should be examined in which that would have been credited Sometimes the investment are sold 'ex-dividend' or bought 'cum-dividend' In such cases he should see the Sold Note or the Bought Note given by the brokers and see that the dividends are subsequently realised and entered in the Cash Book

Bills Receivables The amount of cash received from the bills discounted or at their maturity should be checked into the Bills Receivables Book and Bills Discounted Book It should be seen that all the records have been properly made in the books related to discounts, dishonour or retirement of the bill.

Rents Receivables Leases or agreements with the tenants should be examined to note the rent receivable, the due date and provision for repairs or other allowances The counterfoils of rent receipts should be checked with the Cash Book Any arrears of rent should be duly enquired into If rent is long outstanding, explanation should be sought for to find out whether that is genuine If rent is collected through the agent, it should be vouched with the accounts submitted by him

Commissions Received All the amounts of commission received should be checked with the Commission Accounts submitted by the client to the party from whom the commissions were received Calculations should be made to check the accuracy of the amount

Bad Debt Dividends They should be vouched by examining counterfoils of the dividend warrants or other related documents The auditor should ascertain the amount of debt and the rate of dividend from it and see that accurate amount has been received and entered in the Book

Sale of Investments. Broker's Sold Notes should be examined to vouch the proceeds from the sale of investments. If investments have been sold out 'cum-dividend', the auditor should see that the proceeds have been properly apportioned between revenue and capital receipts.

Sale of Fixed Assets. If fixed assets like land, building, plant and machinery or furniture etc are sold out, their sale proceeds

should be vouched with the sale contracts, correspondence or other available evidence If sold through auction, the auctioneer's accounts should be examined

Share Capital Receipts The vouching of the share capital transactions have been discussed in detail in a subsequent chapter

Other Receipts All the other receipts should be vouched with the help of the related documents, agreements or correspondence

(B) Payment Side of Cash Book

The auditor should vouch the payment side of the Cash Book cautiously Here he will get vouchers which would not originate in the office of the client but from that of other parties dealing with him. That is why such vouchers are more reliable and facilitate his work to a great extent But *he has not only to see that the payments have been actually made* but has to pay attention to the following points also :

(*i*) The payments are in connection with the transactions relating to the business

(*ii*) The payments relate to the period under audit

(*iii*) The items of payments are duly authorised

(*iv*) The payments have been duly received by the payees alone.

(*v*) Correct records have been made in the Cash Book.

The various cash payments should be vouched as follows

Payments for goods purchased For cash purchases the available vouchers would be the Cash Memos received from the suppliers The auditor should see that purchases are duly authorised and vouch them with the Cash Memos For vouching the payments to creditors or credit purchases the receipts from the creditors acknowledging the amounts received by them should be checked He should see that the invoices are duly checked The auditor should enquire if periodical statements are sent by the creditors If so, whether they are properly checked with the Ledger Accounts before the payments are sanctioned

Wages The auditor has to depend upon the system of internal check for wages to a great extent If the system enforced is not sound, he should point this out to his client and disclaim any responsibility in this connection He should ensure himself by testing certain items that the records have been correctly made in the Wages Sheets from the original records such as piecework cards, time-work cards, records of casual labour, overtime or payments in advance or fines imposed He should see that Wages Sheets are duly initialled by those who prepared them and countersigned by some responsible official He should check the totals with the Cash Book

For payment of wages made also he has to depend upon the efficiency of internal check He cannot determine that the payments were actually made to the individual worker as shown in the Wages Sheets He has to satisfy himself with the payments in total He should verify that the amount of cheques drawn tallies with the totals of Wages Sheets He should also see that the deductions for fines, advances etc have been duly adjusted and recorded in the book

Salaries They should be vouched with the Salary Book The auditor should see that it is duly signed by each employee and countersigned by the responsible official For the salaries of Secretary, Manager or other important and senior officials, Board's Minute Book should be examined Their service agreements should also be looked into

Commissions The Commission Book should be referred for their vouching Its calculations should be checked If the commission is paid by way of percentage of sales, the related agreement should also be examined.

Travelling Expenses The auditor should see the rules and conditions for granting travelling allowance and ensure that payment is passed as an order by a responsible official He should see that these expenses are in connection with the business alone and have not been paid in excess If they are fixed, no calculation is required. However, the vouchers for travelling expenses should be examined. It may be noted that the directors are not entitled to travelling allowance unless authorised by the Articles of Association

Establishment Expenses The auditor usually gets vouchers of sufficient validity for expenditures incurred on account of rent, taxes, insurance, advertising and lighting etc His concern will be to see relevant vouchers and ascertain that all the expenditures related to the period under audit have been included and nothing for other periods has been taken into account

Bills Payable. They should be vouched with the bills returned by the payees. If paid through the bank, Bank Pass Book should be referred to

Partners' Drawings They should be vouched with Memorandum Drawing Book or Partners' Drawing Book The auditor should see that it is duly initialled by the partners The Partnership Deed should be examined to ascertain the rules for drawings by the partners and see that they have been followed.

Capital Expenditures. Payments made for the purchase of fixed assets are of the nature of capital expenditure Such expenditures should be carefully recorded in the account books, apportioning the correct amount between the capital and revenue expenditures We mention vouching of some of the items of this nature as follows .

(*i*) Freehold and Leasehold Property. Its vouching should be made with the help of the agreement for sale and conveyance together with the Lease Deeds or Dreds If purchased through a broker, his statement of account should be referred to If purchased through auction, the auctioneer's accounts should be vouched Various expenditures incurred, such as brokerage, auctioneer's commission, legal charges etc should be allowed to be capitalised and vouched by their respective accounts

(*ii*) Buildings In case any building has been purchased it should be vouched with agreement for sale, Title Deeds or receipts for the money paid and the correspondence, if any If it has been constructed under a contract, actual contract should be examined It should be vouched with the architect's or surveyor's certificate and receipts from the contractors If the services of the staff of the client and his materials are used in the construction of the building, allocation of wages and materials is necessary which should be carried on through Journal and Bought Book respectively and not through the Cash Book

(*iii*) Plant and Machinery. Receipt from the vendors would be the relevant voucher which should be duly examined Invoice from the vendors should also be examined If bought from auction, the auctioneer's accounts should be examined ; if bought under the hire-purchase agreement, the agreement and the related vouchers should be seen carefully.

(*iv*) Patents and Copyrights The auditor should see the actual patents Such payments should be vouched with the contract for sale and receipts thereof If he finds that the patents have been secured through research, he should ensure that its expenditure is capitalised. However, he should allow the expenditures for renewals of patents and copyrights to be charged to revenue account

(*v*) Investments Brokers Bought Note and receipts should be examined for vouching of investments The securities themselves should be examined wherever it is possible If purchased cum-dividend, proper allocation of accrued interest paid should be seen If payments have been made through the bank, its Pass Book should be examined

Payments under Hire Purchase and Instalments Such payments should be vouched with the periodical statements received from the hire-trader and vouchers for the payment of instalment The agreement entered into should be examined The auditor should see that payments have been properly apportioned between principal and interest, as each instalment includes both

PETTY CASH BOOK

The auditor should examine the system of internal check existing for petty cash and find out its weaknesses, if any. It should be satisfactorily enforced by the client since chances of misappropriation of cash are numerous However, the auditor should disown any responsibility to the client if the system of internal check for the petty cash is inadequate, since he cannot completely check all the petty cash expenditures of the year under audit

The cheques drawn for petty cash should be vouched from the credit side of Cash Book to debit side of Petty Cash Book. The auditor may apply test check in examining the petty cash vouchers at random since there may be innumerable small transactions But it should be done as exhaustively as possible He should be cautious about the validity of vouchers presented to him He may find alterations in or absence of vouchers for several petty transactions for which he must seek proper explanation He should see that Petty Cash Book has been maintained on Imprest System properly. If not so, he should direct the attention of the client to this point and suggest the adoption of such system He should ascertain that credit to employees is not given from it. For purchases of stamps, Postage Book should be consulted He should also check cross-casts and balance of the Petty Cash Book It is essential to check the balance of petty cash in hand It would be best if he personally visits and counts it on the date of the Balance Sheet If it is not possible he should instruct the client to get the balance deposited into the bank

BANK PASS BOOK

The deposits into or withdrawals from the bank are recorded in the bank column of the Cash Book which has to be vouched carefully Bank Pass Book is of great help in vouching these records As noted earlier, daily receipts should be banked in tact to ensure proper check

Deposits into the bank, which may be in the form of fixed, current or savings bank deposits, should be vouched with the counter foils of pay-in-slip book In case the customers have paid directly, bankers' advice notes should be obtained and consulted The auditor should see that the dates of deposits are entered into the Pass Book and Cash Book do not differ materially If it is so, he should obtain from the bank the original pay-in slips He should be alert specially with regard to deposits made into the bank prior to the date of closing the accounts It is because the bank might not have credited such deposits till the next period But an auditor may vouch this too with the help of counterfoils of the pay-in-slips duly initialled by bank authorities, because the date of deposit may be obtained from them The client should be advised that it is not a good practice to record all the remittances by the debtors in the period under audit even

though they are received after the date of closing the accounts It would increase the amount of cash balance unnecessarily

Withdrawals or payments out of bank should be vouched with the counterfoils of the cheque book In case the bank has been ordered to transfer certain amount to other accounts, the voucher available to him would be the receipts from the payee or copy of advice given by client to the bank to this effect The names of the payees and dates should tally in both the Cash Book and Pass Book For the cheques dishonoured, it should be seen that it has been properly recorded in the Cash Book For bank charges, interests, discounts or other incidental expenses, Bank Pass Book should be examined and also the letter from bank to that effect The auditor should be vigilant with regard to contra entries in Cash Book or statement since they may be passed unnecessarily to avoid any dishonest handling of cash He should see that contras appearing in Cash Book but not in the statement or vice versa are quite in order

He should obtain from the bank the opening and closing balances A copy of Reconciliation Statement prepared by the clients staff should be examined and checked carefully Proper testing of such statement is essential

The auditor should guard against fictitious pass books being presented to him and in case he is given a modern *loose-leaf* pass book, he should examine it cautiously as there are dangers of its pages being misplaced or fraudulently substituted

QUESTIONS

1 What is vouching ? Explain how would you vouch Cash Book ?

2 "Vouching of Cash Book requires more attention " Explain it and discuss how would you vouch payment side of the Cash Book

3 Define vouching What are the special points to which the auditor must pay special attention in vouching payments

4 How would you vouch the following

(*a*) Cash sales

(*b*) Receipts from debtors

(*c*) Commission

(*d*) Capital expenditures

5 How would you, as an auditor, vouch the Petty Cash Book an d Bank Pass Book ?

6 As an auditor, how would you vouch the following.

(i) Payments under hire-purchase system

(ii) Payment for wages

(iii) Payment for commission to travelling agents

(iv) Sale of investments.

(v) Rents receivable.

7 Describe the salient features of internal check for and vouching of wages in an industrial concern

8 What precautions should be taken for vouching payments? How would you, as an auditor, vouch payment side of Cash Book?

8

Vouching of Trading Transactions

Numerous trading transactions are carried on in a business concern as cre 'it plays an important role in the business world. Several business undertakin^s owe their existence and prosperity to it They have to purchase as well as sell on credit An auditor has to face the problem of vouching records of such transactions as well It involves vouching of Purchases Book, Sales Book, Purchases and Sales Return Books, Bills Receivable and Payable Books etc, which have been discussed below

Purchases Book The auditor should examine the system of internal check for purchases made and ascertain whether it is effectively enforced or not If he is not satisfied with it, he should vouch the Purchases Book with the invoices exhaustively While examining the invoices, he should pay special attention to the following points

1. They are made out in the name of the client.
2. The dates mentioned therein tally approximately with those of the Purchases Book
3. They are initialled by those whose duty was to check them
4. Trade discount has been already deducted and only net amount has been entered in the Purchases Book. But cash discount has not been accounted for in them [1]
5. The kinds of goods purchased are of a nature usually traded in the client's business

1 The distinction between trade discount and cash discount must be clearly understand A *trade discount* is an allowance made by one concern to another in the same trade in the form of a percentage of catalogued price of each article It is deducted in the invoice and only net figure is recorded. On the other hand, the *cash discount* is an allowance given by the seller to the purchaser for prompt payment or payment within the period of credit by the latter It is recorded in Cash Book having separate column for discount, and posted to the debit of the account in the Purchases Ledger It should never be deducted from the invoice before the entry is made in the Purchases Book, as is sometimes done when such discount is regularly received

6 No invoices are missing If he finds some of them missing he should prepare a list of such missing invoices and obtain copies of duplicates thereof If he is unable to get a duplicate of such invoices, he should report it to his client

The auditor should cancel out each invoice as soon as it is passed so that it may not be reproduced To ascertain that no fictitious purchases have been entered, he should check and compare the entries in the Purchases Book with the Order Book and Goods Inwards Book Sometimes, the invoices are suppressed and goods received are included in the closing stock to inflate profit. To find this out, he should compare the Goods Received Book with Purchases Book for goods received towards the end of the financial period. He should also check those invoices which relate to the next period and see that no entries have been made in the Purchases Book if the goods have not been received during the financial year under audit

To find out that no invoice has been omitted from being entered into the Book, he should also examine the creditors' statement and compare it with the Ledger balances.

An independent test may be made to find out whether any large purchases have been omitted from entering in the books He should calculate the percentage of gross profit to sales for current as well as previous years and compare them If the percentage varies to a great extent, explanation should be sought ascertaining the reasons for this variation If satisfactory explanation is not available, he should pursue the matter in detail

He should also see that no purchase of capital goods has been entered into the Purchases Book but recorded in respective fixed assets accounts,

In case contracts for forward purchases are entered into, he should see that they are not abnormal in amount If it is so, it should be mentioned in the Balance Sheet by way of a note If there is probability of huge loss on such contracts, he should advise that a provision should be made against such loss

It has been rightly emphasised that "If, however, *exceptional* forward commitments have been entered into, the outcome of which may adversely affect the financial position of the company suitable disclosure should be made in the Balance Sheet, and the auditor should qualify his report if it is not made "[1]

He should also check the casts and cross casts of Purchases Book

1 *Rex v Bishirgian and Others*, also known as "Pepper Pool" case quoted in Spicer and Pegler, *Practical Auditing* (second Indian edition, 1963), p. 65.

Purchases Returns Book The system of internal check for this also should be examined carefully to ascertain that full credit is obtained for all the goods returned The auditor should vouch the Purchases Returns Book with the Credit Notes received from the creditors He should see the Goods Outward Book and all related correspondence to ascertain that there is no suppression of Credit Notes He should also examine the entries in the Purchases Returns Book for early part of the next period to find that there is no manipulation in accounts for the purchases Fictitious purchases may be included in accounts and later on entered as returned in the next period The auditor should guard against such manipulation in the accounts He should check the casts and cross casts of the Book

Sales Book To vouch the Sales Book the auditor gets indirect evidences in the form of duplicates or copies of invoices which are not completely reliable He has to depend upon the efficiency of internal check system in force concerning sales from the time the order is received till the despatch of goods To ascertain that all the sales of the year are included in the Book, he should check the Sales Book with Order Book and Goods Outwards Book, and also with the duplicates of the invoices despatched He should make test checking of a few sales transactions from beginning to the end, *i e* from the customer's orders received till the ultimate receipt of cash from him

If any heavy sales have been shown in the Book, the auditor should make particular enquiry in this regard and see that the closing stock does not include such goods

The Sales Book should be vouched carefully for the sales items of the last few weeks prior to the close of the period of audit. Reference should be made to the Goods Outwards Book of the subsequent period to find out if any fictitious sales have been entered to inflate profit and subsequently shown as returned

To ensure that goods recorded as sold actually left the premises of the concern, he should check a representative number of sales invoices with the Goods Outwards Book

In case sales of fixed assets of capital nature have been made and entered into the Sales Book, he should see that it is posted to respective assets accounts and not in the sales account.

He should be careful in examining the goods sent by the client on 'sale or return' or by V P P or goods sent by him on consignment and see that they are not entered into the Sales Book unless the sales have already taken place "Where goods have been sent to customers on sales or return, the auditor should ascertain that unsold goods in the hands of customers at the date of the Balance Sheet are not treated as sales, but are brought into account as stock in the hands of customers, at cost price, a percentage being deducted where

necessary for damage It is primary rule 'that no credit should be taken for profit on a sale until the sale is actually affected "[1]

Where the goods have been sold on hire-purchase system, he should see that the amount has been properly apportioned between revenue and capital Credit in each year should be taken only for such interest as has actually accrued during the accounting period.

If the auditor finds that certain contracts for forward sales have been entered into, he must see that no profit has been taken into account in advance and only those goods which have been actually delivered should be treated as sales

In a manufacturing or wholesale business concern where the goods are sold subject to sales tax, the auditor should see that the amount of sales tax has not been included in the sale price of the goods sold He should also see that sales tax has been shown separately in sales invoices and posted in Sales Tax Account.

He should check casts and carry forwards of the Sales Book and posting to the Sales Account

Sales Returns Book He should enquire into the system of recording goods returned by the customers and of issuing Credit Notes to them for the same He should, then, vouch the Sales Returns Book with the duplicates of the Credit Notes issued He should refer to the Goods Inward Book and the correspondence on the subject He should also check the casts of the Book and the postings therefrom to the credit of the customers' account

Bills Receivables Book The auditor should examine the actual bills to verify the balance of Bills Receivable Account in the Ledger He should see that they are not overdue and are correctly drawn, stamped and accepted The Cash Book and the Pass Book should be referred to check the amounts received from matured and discounted bills With the help of receipt side of the Cash Book he should also check that the bills have been met when due

In case the bills are in possession of bank for collection purpose, he should obtain a certificate to that effect from the bank If there is a contingent liability with regard to discounted but unmatured bills, that should be shown in the Balance Sheet by way of a note He should, however, check the casting of and posting from the Book.

Bills Payables Book. It should be vouched with the Cash Book and the bills returned He should ascertain that all the bills were met on maturity. The balance of Bills Payable Accounts should be checked with the outstanding bills shown in the Bills Payable Book

1. Spicer and Pegler, *op cit.*, p 69

by checking their due dates He should also check the casting of and posting from the Book

Journal Proper In a business concern where various Subsidiary Books are maintained, Journal is used for recording those items which cannot be passed through any other book of original entry It usualy contains the records of transactions such as opening, closing and various adjusting entries for issue, allotment and forfeiture of shares, and other special entries etc The narration is given in general, after each entry in it, but if it is not there, the auditor should insist for the same

The auditor should vouch the Journal as carefully as the Cash Book because it contains the records of varied and important transactions, sometimes of complicated nature having a direct bearing on the Final Accounts Every entry should be supported by a proper and valid voucher which may be in the form of correspondence, contracts, minutes, resolutions etc The usual items appearing in Journal should be vouched as follows

Opening entries They should be vouched with reference to the previous Balance Sheet and working papers of the previous year In case of a new company, the opening entries for the purchase of business should be vouched with the contract with vendors, company's Articles of Association and the Director's Minute Book.

Closing entries They should be checked carefully as they would consist of transfers from nominal accounts to the Profit and Loss Account, depreciation, reserves allocation between capital and revenue etc Each case should be vouched with the relevant evidence available He should see that only correct closing balances are transferred

Adjusting entries The auditor should see that all the incomes and expenses of the year under audit have been taken into account All the outstanding liabilities, income received in advance, accrued income or prepaid expenses etc, should be carefully examined and scrutinised with relevant vouchers For a detailed description of these items, refer to next chapter on "Vouching of Personal and Impersonal Ledgers"

Rectification entries The actual errors should be carefully examined and he should see that correct entry has been passed It should also be seen that they are authorised by some responsible person, which is usually done in case of such entries

Share Capital entries They should be vouched with Application and Allotment letters, Minute Book, Prospectus, Company's Articles of Association, Register of Shareholders etc

Dishonoured Bills They should be vouched with letter from the bankers giving intimation about the dishonoured bills

Bad Debts They have to be authorised by some responsible person, which should be enquired There should be documentary evidence for it which should be carefully examined by the auditor He should seek explanations from the client in case of any doubt

Other entries. Any other entry in the Journal should be vouched carefully with the written authority of some responsible person or correspondence or contracts etc , as the need may be

After vouching the Journal, the auditor should check the casting of and posting from the Journal

QUESTIONS

1 Describe the system of internal check for purchases and discuss what special attention should be made while examining the invoices?

2 Explain in detail as to how would you, as an auditor, vouch the Purchases Book?

3. Explain the procedure of vouching the Sales Book

4 How would you vouch, as an auditor, the Purchases and Sales Returns Books?

5. What is Journal Proper? How should various entries of Journal Proper be vouched?

6. How would you vouch the Bills Receivable and Payable Books?

7 How would you vouch the following

(a) Sale by V P P.

(b) Adjusting entries

(c) Purchases Returns Book

(d) Sale under hire purchase system.

(e) Contract for forward sales

9

Vouching of Personal and Impersonal Ledgers

Postıng from varıous subsıdıary books ıs made ın the respectıve counts ın the Ledger Book The Ledger may be sub-dıvıded as rsonal and ımpersonal as ıt contaıns accounts maınly of two types— rsonal and ımpersonal *Personal* accounts are related to persons d, ın a tradıng concern, usually to those persons from whom the ›ods are purchased or to whom the goods are sold The former are own as credıtors and theır accounts are maıntaıned ın Purchases dger The latter are known as debtors and theır accounts are corded ın Sales Ledger Personal accounts may also be related to counts of the proprıetor or partners such as Partner's Capıtal and ırrent Accounts etc, but these accounts are maıntaıned ın ıpersonal Ledger

Impersonal accounts, as the name suggests, are related to the counts affectıng the busıness and not persons These accounts are two types—nomınal and real *Nomınal* accounts are related to ms of profit or loss, ıncome or expendıture, e g rent, salarıes, mmıssıon, accounts etc *Real* accounts are concerned wıth the sets such as buıldıng, plant and machınery or furnıture accounts

PERSONAL LEDGER

It consısts of Purchases and Sales Ledgers The auditor should uch them carefully after vouchıng the varıous subsıdıary books z, Purchases Book, Cash Book, Purchases Returns Book, Bılls yable Book and the Journal Proper) and checkıng postıngs from em He should check the casts and the balances of the Ledger counts He should examıne the Ledger accounts to see that he s already vouched every ıtem ıncludıng the balances brought forırd at the commencement of the perıod If the Ledger ıs maınned on the Self-Balancıng system, the total of the lıst of the edıtors and debtors should agree wıth the total of the balances own ın the Credıtors' and Debtors' Ledger respectıvely.

(1) Purchases Ledger

In the Purchases Ledger the accounts of various creditors, from whom the goods are purchased on credit, are maintained

The auditor should compare the statement received from the creditors with the balances of the Purchases Ledger In case the statement of the creditors is not available, he should ask for it from the client or should correspond directly with the creditors ascertaining the balances on the date of the Balance Sheet If the two disagree, it should be inquired into and the proper explanation must be sought A possible reason may be that goods may have been despatched by the creditor on or before the date of the Balance Sheet but actually the goods may not have been received by the client by that date

In case certain accounts of creditors are in dispute or claims have been made by them and a law suit is pending, it would also result into disagreement of creditor's statement and Purchases Ledgers. The auditor should see that for such contingent liability adequate provision has been made and shown in the Balance Sheet by way of a note to that effect If adequate or no provisions have been made for such claims and the fact has not been mentioned in the Balance Sheet, it must be stated in his audit report.

If the debit balance appear in the Purchases Ledger, which may be on account of payment made in advance, returns or allowances etc, that must be very carefully enquired into by him In case the payments have been made in advance and the goods have not been received but property or ownership in the goods has passed to the client 'Goods-in transit Account' should be opened and the balance closed If the property has not passed to him, the debit balance should be allowed to remain In any case, the auditor should enquire whether the debit balances are bonafide or not They should be shown in the Balance Sheet with the sundry debtors rather than as deducted from the sundry creditors

(2) Sales Ledger

• Having checked the postings from various books of original entry into the Sales Ledger, the auditor should proceed with the castings of the Sales Ledger and examination of the balances with the help of the List of Debtors He should see that the trade discounts, goods sent on approval or on consignment have not been included in the balances The opening debit balances should also be checked with the help of the previous audited Balance Sheet

In case the Ledgers are maintained on the self-balancing system, he should see that the total of List of Debtors agrees with the balance of the particular Debtors' Ledger Adjustment Account in the General Ledger If there is disagreement between the two, errors should be located and rectified.

He should ensure by cautious examination that no fraud has been committed by passing fictitious entries on the credit side of the Sales Ledger by way of allowances or bad debts etc. To ensure accuracy further, a statement of account should be sent to each debtor to confirm the balances The auditor should instruct that the replies should be sent to him directly He should then see that the balances shown in the client's Ledger agree with those confirmed by the debtors If there is any disagreement, proper explanation must be sought for

In case the credit balances appear in the Sales Ledger, the auditor should ascertain that they are bonafide He should see that they appear in the Balance Sheet along with the sundry creditors rather than as deducted from the sundry debtors.

The auditor should then ascertain the amount of bad and doubtful debts It has to be examined carefully as given below.

Debtors' Ledgers The auditor, having checked the accuracy of the balances in the Sales Ledger should examine whether all the debts are recorded or not There may be certain debts whose recovery may be doubtful or which may be irrecoverable at all The auditor should obtain a schedule of such and doubtful debts from the client duly certified He should scrutinise it very carefully noting the following points —

(i) The conditions and the period of the credit allowed by the client.

(ii) The age of each debt.

(iii) The regularity of cash payment for such debts and fulfilment of conditions of credit

(iv) Whether payments are made on account and the balance tends to increase without any trade done

(v) Whether new goods are being supplied whereas old accounts stand and are being paid in instalments.

(vi) Whether cheques or bills drawn for payment have been dishonoured

(vii) Whether the notes appear on accounts such as "account stopped", "suspension of payment", "in insolvency", "in liquidation", "suit filed against", "disappeared" and "address unknown" etc

Noting the above points, he should see that the schedule contains all the bad and doubtful debts He should examine the Cash Book of the next period and find out if any debtor has paid in full If it is so, it should be cancelled from the schedule The position of other debts also may be confirmed looking into the age and

regularity of payments etc. However, it is to be noted that merely the age of the credit cannot determine whether a debt is good or not. The length of credit varies in different businesses and it also depends upon the class and status of the customer and the case with which the client can keep touch with them. He should also see whether certain debts which are doubtful have been included in the schedule or not. He should then discuss each debt with the client or a responsible official, and hear explanations regarding the debts marked by him as doubtful, in order to form an idea of the proportion thereof which may subsequently be recovered. The special circumstances obtaining in the particular business should not be ignored while forming any opinion.

He should see that any bad debt is not written off so long as there is slightest hope of its recovery. If it is written off and subsequently the money is realised in part or full, that may be misappropriated since no debit appears in the Ledger therefor. It should be seen that it is properly recorded. In case there is no hope of its recovery, it may be written off but only with proper sanction of some responsible official.

The auditor should examine the provision or reserve for bad and doubtful debts also. He should see that all the bad debts have been fully provided for and the doubtful debts have been provided to the extent estimated to be irrecoverable. If he finds that insufficient provision has been made, he should persuade the client to make additional provision. In case the client does not yield to his persuation, he should refer the matter in his report. If necessary, the auditor should obtain a certificate from a responsible official to the effect that the provision made in this connection is, in his opinion, sufficient.

The auditor must consider the whole question of bad and doubtful debt with due attention[1]. Any carelessness on his part may hold him liable, as such debts affect the profit or loss and financial picture of the concern. If correct estimates of such debts are not made, the Trading and Profit and Loss Account and the Balance Sheet will not show the correct financial picture of the concern. The debtors represent the credit sales that have been credited to Trading Account but which have not been paid for. If part or full payment is not received the sales would not represent loss but would show earnings, and profits will be inflated to that extent. Similarly, the debtors will be shown as overstated in the Balance Sheet. But the auditor's difficulty is to estimate the amount of loss. No hard and fast rule can be laid down for its estimation. He should, therefore, be careful in estimating the amount of bad and doubtful debts.

1 Refer to *re London and General Bank* (1895) and *A E Green & Co v. The Central Advance and Discount Corporation Ltd* (1920).

IMPERSONAL LEDGER

Impersonal Ledger, known as General Ledger or Nominal Ledger, contains nominal and real accounts which affect the Trading and Profit and Loss Account and Balance Sheet of a concern substantially The auditor must vouch them intelligently and carefully to satisfy himself with regard to the truth and fairness of the net results of the accounting period and the financial state of affairs on the date of the Balance Sheet

He should try to check the entries in the Impersonal Ledger in detail He should examine it exhaustively since the entries in it are numerous, except in case of some very large business undertakings Detailed checking is necessary because it will also ascertain the accuracy of Personal Ledgers to a great extent It has been observed in practice that manipulation in the personal accounts is concealed through passing fictitious entries in the impersonal accounts If the auditor examines it thoroughly, such frauds may be detected

Posting in the Impersonal Ledger will be mainly from the various subsidiary books, Cash Book and the Journal proper In the various chapters we have already discussed the vouching of these books While vouching them, the auditor would have already consulted the vouchers in connection with the various items whose accounts are found in the Impersonal Ledger For example, when he vouches the Cash Book, he vouches the receipts from commission, rents dividends etc , and these accounts will be there in the Impersonal Ledger Even then, the auditor should note the following points in connection with the vouching of the Impersonal Ledger.

(*i*) Posting from subsidiary books to the Impersonal Ledger should be thoroughly checked

(*ii*) Posting from the Cash Book to the Impersonal Ledger should be checked in detail It should be seen that all the items in the former have been posted correctly to the relevant impersonal accounts It is necessary because sometimes the particulars entered in the Cash Book are insufficient to indicate the account to which the posting should be made The auditor should examine the vouchers thoroughly to find the correct item and see that it has been posted to the relevant account only He should also guard against the mistake of wrong posting because of similarity in names. For example, rent is an item which may be received as well as paid by the client There are chances that the rent received is posted as rent paid or vice versa. He must be careful about such wrong postings

(*iii*) The monthly totals in the books of prime entry should be checked with the relevant accounts in it.

(*iv*) He should check and verify the casting of the Impersonal Ledger.

(*v*) He should check the balances of the various accounts in it and compare them with the balances shown in Trial Balance

(*vi*) He should also check the balances of the various accounts with the respective items shown in the Trading and Profit and Loss Account add Balance Sheet.

(*vii*) Posting from the Journal should be very carefully checked since many transactions of impersonal nature are passed through the Journal He must see that sufficient vouchers are available for all the entries made in the Journal

(*viii*) The adjusting entries passed in the Journal need special attention He must see that all the adjusting entries have been duly posted to the relevant accounts

The accounts dealing with the outstanding assets and liabilities in the Impersonal Ledger should be examined thoroughly by the auditor and we discuss them in detail below

Outstanding Assets and Liabilities

A well-known maxim in Accountancy is that while preparing the Profit and Loss Account all the profits or losses, incomes or expenditures etc, *related to that particular year* should be included in it, but nothing which relates to the previous or the following year should be taken into account In practice, we find that in every business there are some outstanding assets or liabilities which have to be adjusted into the accounts To ascertain the true profit or loss for the year under consideration, all such outstanding assets or liabilities, not brought into accounts so far for some reason or the other must be brought into account.

Adjusting entries for such items are passed through the Journal In some cases a Memorandum Book is used in which all such records are maintained If it is so, the auditor should obtain a certificate from some responsible official to the effect that all such outstanding items have been included in the Book However, it would not relieve the auditor from his responsibility of intelligent enquiry about such items. Such a Book will be of great use to him as it will make him familiar with the usual items for adjustments and facilitate the comparison of figures of such items for two given periods

The auditor should see that such outstanding assets and liabilities are shown as assets and liabilities respectively in the Balance Sheet. It is to be noted that record for such adjusting items are made twice in the Final Accounts if the adjustment is made after balancing the accounts and preparation of the Trial Balance

(A) Outstanding Assets

Assets remaining outstanding at the date of the Balance Sheet may be either pre-paid expenditure or accrued income. *Pre-paid*

expenses are those expenditure which have been incurred during the accounting period but a part or whole of which may relate to the period subsequent to the date of the Balance Sheet It may arise because of the advance payments made by the concern *Accrued incomes* are those incomes which may be accrued or due to the concern but have neither been received by it nor recorded in its book of account But such incomes will be received by the concern in next accounting period

(i) **Pre-paid Expenses** There may be certain expenditures which have already been incurred, but which do not belong in part or full to the year under audit for which the Final Accounts are prepared These pre-paid expenses represent working capital and usually are items which will be converted into expenses in short time They should be excluded from the Profit and Loss Account, but must be shown in the Balance Sheet as assets Examples of some of the pre-paid expenses are given below

(*a*) *Insurance paid in advance* Insurance premium on policies taken are usually payable in advance Part of the premium paid may belong to the period subsequent to the date of the Balance Sheet This amount should be calculated and taken into account If, for example, an amount of Rs 200 has been paid by way of premium for one year on 1st April, 1975 and accounts are closed on 31st December, 1975 it would mean that advance premium has been paid for three months (January, February and March 1975) subsequent to the date of Balance Sheet Thus Rs 50 will be the amount of premium paid in advance. This amount of Rs 50 should be excluded from the Profit and Loss Accounts and shown in the Balance Sheet as an asset that year The auditor would vouch the amount with the help of premium receipt and, if he feels necessary, he may even inspect the actual Policy taken He should see that the amount has been correctly apportioned between the two periods and properly recorded in the Profit and Loss Account and the Balance Sheet

(*b*) *Rents paid in advance* As in the case of insurance premium the rents may also be paid in advance Calculations may be made for such payments in advance for the period subsequent to the date of the Balance Sheet and shown accordingly in the Profit and Loss Accounts and the Balance Sheet The auditor should see the agreements, or the lease and receipts etc , to find out the correct position

(*c*) *Advertising Expenses* Payments in connection with advertisement may also be made in advance Such advance payments, not related to the period under audit, should be carried forward If any stock of advertising materials, such as posters, boards etc , are left, they should also be examined properly They may be valued at or under cost, providing for the required depreciation, if necessary. They should also be shown as assets in the Balance Sheet

(*d*) *Pre-paid Commission* It arises, in general, when the salesmen operating on a commission basis are permitted to draw against

future earnings The auditor should see the arrangement between the client and the salesmen as to the payment of commission He should, also see the report or statement submitted by the salesmen to determine the commissions earned and this item should be verified against the withdrawals of each individual to determine the amount of pre-paid commission if any Then after vouching the commissions, he should see that the correct records have been made as to the prepaid commissions in the Profit and Loss Accounts and the Balance Sheet

(e) *Pre-paid Taxes and Rates etc* In a majority of cases, the tax period does not coincide with the accounting period Usually accounts are closed on 31st December whereas taxes have to be paid till 31st March It results into pre-payment of taxes The auditor should be thoroughly familiar with all the types of taxes He should scrutinise the copies of tax returns and tax bills Then he should consult the Cash Book for the taxes paid This way, he can find out the amount of taxes paid in advance He should see that these payment's have been correctly treated in the accounts.

(f) *Pre paid Interest and Discounts* Interest is payable for loans taken or on debentures etc At the Balance Sheet date, certain interest might be pre-paid The auditor must trace if interest and discounts are pre-paid by comparing the agreement, rate of interest, conditions of payment of interest, and the actual amount of interest paid at shown in the Cash Book He should also see that such amount of interest and discounts have been shown correctly in the final accounts

(ii) **Accrued Incomes** Accrued incomes are those incomes which are accrued or due or earned but have not been received during the year under audit But ultimately they will be received by the concern Such incomes should be included in the Profit and Loss Account and shown as assets in the Balance Sheet Care should be taken that these incomes are not credited in the Profit and Loss Account which are not likely to be received Examples of certain accrued incomes are given below

(a) *Rents Receivables* During the year, the rent might have been due or accrued from the tenants but not paid by them till the date of the Balance Sheet That portion of the rents receivable which may not be recoverable or may be doubtful should not be taken into account and a provision should be made for this in the Profit and Loss Account The auditor should see the copy of receipts given to the tenants and agreement, if any, to ascertain the balance of rents receivable.

(b) *Interest and Dividends* Interest on debentures or other investments which are accrued but not received should also be taken into account If the rate of interest is fixed there would be no diffi-

culty in its calculation for the amount to be taken into account Dividends on shares, which are due but not received, should also be taken into account However, the dividends on ordinary shares need not be taken into account unless information about the amount of dividend is available

(c) *Commission, royalty etc , receivable.* The amount of commission due or accrued but which will be received later on should also been taken into account The rate of which the commission has been calculated should be ascertained by the auditor and he should check the amount of the accrued commission taken into account accordingly Similarly, the royalty receivable, which is due from the lessee, should also be recorded properly To ascertain the amount of the royalty, the auditor should examine the agreement between the landlord and the lessee

(B) Outstanding Liabilities

In every business concern, certain outstanding liabilities exist on the date of the Balance Sheet All such liabilities, which belong to the period for which the final accounts have been prepared, should be adjusted in the books of account It is necessary with a view to ascertain the correct amount of net profit for the year If such outstanding liabilities are not included, it will inflate profit and to that extent the Balance Sheet will not present the true state of affairs of the concern.

The auditor has to be careful and see that all the outstanding liabilities have been taken into account But it is rather difficult for him to ascertain all the outstanding liabilities, because it is very easy to suppress or conceal a liability by not indicating anything in the books to that effect The auditor will have to fall upon his own wisdom and experience to ascertain the existence of such liabilities by thorough checking Most of the outstanding liabilities are of common nature in different concerns and auditor will have simply to look into those transactions

Such outstanding liabilities may be of two types , (*i*) the unpaid expenses and (*ii*) the unearned incomes, which are discussed below

(i) Unpaid Expenditures Unpaid expenditures are those which have already been accrued but not paid till the date of the Balance Sheet These expenditures must be included in the Profit and Loss Account and shown in the Balance Sheet as liabilities Some of the usual types of unpaid expenditures are as follows .

(*a*) *Wages and Salaries* Wages and salaries may remain unpaid on the date of the Balance Sheet if the date of payment of salaries and wages does not coincide wi h the date of the Balance Sheet Such unpaid wages and salaries, though earned by the workers and employers, have to be taken into account to ascertain the true

profit or loss for the period The auditor should see that such outstanding wages and salaries have been calculated and adjusted into the accounts They should be shown in the Balance Sheet as liabilities

(*b*) *Freight and Carriage* Freight and carriage due on the goods purchased or otherwise at the close of the accounting period may remain unpaid if the accounts have not been rendered by the agents concerned The amount of such freight and carriage should be ascertained and brought into account The auditor should see that it has been debited into the Profit and Loss Account and shown in the Balance Sheet as liabilities As a further check, he may compare such outstanding freight and carriage with that of the previous year and mark the abnormal changes if, any The auditor should see that the whole of outstanding freight and carriage for the year has been taken into account

(*c*) *Rent, Rates, Electricity etc* the various expenses for rent, rates, taxes, electricity and water etc might have been due for payment by the client but might not have been paid by him till the Balance Sheet date Such outstanding expenses must be brought into account and shown as liabilities in the Balance Sheet The auditor should ascertain such outstanding expenditures by examining the relevant documents For rent, he should examine the agreement or the lease and amount paid so far as shown by the Cash Book and the receipts issued by the landlord For water, electricity, telephone bills etc, he should see the demand note received by the client and payment made till the date of Balance Sheet For rates and taxes also, the tax bills, tax returns or the demand notes should be scrutinised He should be careful to see that all such outstanding expenditures have been brought into account

(*d*) *Commissions* The commission is payable to various agents and salesmen It is possible that the commissions might not have been paid to them for the services rendered till the date of the Balance Sheet The reason may be that they might not have submitted the statement of account for that period In case some amount has been given to them in advance, that should be deducted before arriving at the correct amount of outstanding liability in this respect Similarly, if they collect the amount directly from the customers and set off their commission against the amounts thus realised, that should be properly guarded against and taken into account Such a practice is not desirable and proper safeguard should be resorted to against it

In case the commission is to be paid to the *del credere* agent such commission should also be taken into account In case of such agents, the important point to remember is that commission to him is not payable if the customer does not pay the money due to the concern The commissions on the amounts to be received from the customer whose financial position is doubtful or who has become insolvent need not be taken into account.

(*e*) *Interest on Loans and Debts* If the interests on loans and debentures are payable, but not paid till the date of the Balance Sheet, it must be taken into account as a liability The auditor should examine the agreement, the rate of interest and the interest paid so far as shown by the Cash Book. He should ascertain the amount of such interests due and not paid and see that proper records have been made in the books of account

(*f*) *Audit Fees* Whether the audit fees due should be treated as an outstanding liability or not is a controversial point In any case, the audit work is never complete at the date of the Balance Sheet Sometimes it is not even started by the date Nonetheless, the audit work relates to the period covered by the accounts, and it is advisable to take it into account for that period. It should be debited to the Profit and Loss Account and shown as the liability in the Balance Sheet. In case the audit fees have not been agreed, an estimated fee on the basis of the past experience should be brought into account

(ii) **Unearned Incomes** Certain incomes may be received during the year under audit though they might not have been earned during that period They will be *earned* only in the following year For example, the amount of rent, commission, dividents, interest, discounts etc , might have been received in advance Such incomes, which belong to the period subsequent to the date of the Balance Sheet, should not be credited to the Profit and Loss Account as income but should be shown as liabilities in the Balance Sheet

In respect of such incomes, the auditor should calculate that portion of money received which has been received in advance He should see that it has been entered as liability and not as income He should examine the related vouchers to ascertain the exact amount Special care should be taken in tracing such liabilities and see that they have not been understated in the accounts.

Contingent Liabilities

A contingent liability, as the name implies, is one which is not actual liability but which will become a liability on the happening of some events in future It may involve payment of money in future if it turns out to be an actual liability

According to Montogomery, "The term 'contingent liability' should be used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arises from past circumstances or action which may or may not become a legal obligation in the future, and which, if paid, gives rise to a loss or an expense or an asset of doubtful values " Since the future is uncertain, what will happen in future cannot be correctly ascertained But it may be guessed on the basis of past experience whether certain contingent liability may turn into actual liability or not The auditor may

ascertain such liability with the help of account books, correspondence, minute book and other related evidences

The examples of such contingent liabilities are as follows

(*i*) Bills of exchange are usually discounted before the date of their maturity with a banker In case the bills discounted are met at the date of maturity, no liability will accrue But if at the date of maturity of the bill, the acceptor does not meet it, the holder of the bill (i e the bank) has got a right of recourse against the drawer or any endorser of that bill When the bill is discounted, it is a contingent liability, but it becomes an actual liability if it is not met at the due date as the payment for that bill will have to be made to the bank Unlike other liabilities, the amount of such contingent liability is known and can be easily ascertained The right policy in this connection would be to make provision against it.

(*ii*) A law suit may be pending against the client, under which sums are claimed for the damages for alleged breach of contract, or action for libel, or infringement of the patent or copyrights etc These liabilities may be certain or uncertain If the client has reason to believe that he has committed a breach, the liability is certain, otherwise not Like contingent liability for bills discounted, the amount for such contingent liability is unknown and a definite figure cannot be attributed to it.

(*iii*) A company may have guaranteed the due payment of interest and principal of Debentures issued by another company This guarantee constitutes a contingent liability of the guaranteeing company If the company which issued the Debentures is unable to pay the interest or principal when due, the guaranteeing company will have to pay the same

(*iv*) There may be certain contingent liability which may result into the acquisition of corresponding assets on the happening of certain events in future [1] For instance, the client may acquire a disputed building if there was a pending case The practice is not to make any reference of such contingent liability in the Balacce Sheet but it is advisable to put notes if the amount involved is large The instances of such contingent liabilities are liabilities under trade contracts, or under agreements for the services etc

The contingent liabilities and provision therefor should be shown in the Balance Sheet They are shown in Balance Sheet by way of a note only and not included in the amount column.

The Indian Companies Act, 1956 mentions the procedure of its being shown in the Balance Sheet Part I of Schedule VI, substituted by the Companies (Amendment) Act No 65 of 1960, gives the Form[2] of the Balance Sheet in detail This Form includes contingent liabili-

1. Taylor and Perry, *Principles of Auditing*, pp 140-41
2 This form has been given the end of Chapter 22

ties also, which are to be shown under 'Current Liabilities and Provisions' The contingent liabilities have to be shown by way of footnote to the Balance Sheet under the head, 'other money for which the company is contingently liable', but should be shown separate from other items in the foot-note It also mentions the instructions, "The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified"

The auditor should try to ascertain all the contingent liabilities and see that they have been shown in the Balance Sheet In case of a company he should see that the above provisions have also been followed He should also see that a provision has been made against such liabilities, specially if the amount involved is a considerable one He should also verify such contingent liabilities For instance, to verify the bills discounted, he should examine the records in the Bills Receivables Book He should ascertain what bills were still unexpired at the date of the Balance Sheet which wave been discounted before such date He should than find out whether some information is available as to the dishonour of the discounted bills on the due date. Likewise, he should verify other contingent liabilities also.

ALLOCATION OF EXPENDITURES BETWEEN CAPITAL AND REVENUE

All the expenditures of a business concern may be divided into capital and revenue expenditures *Capital expenditures* are those expenditures which are incurred for purchasing fixed assets or enhancing the earning capacity of the concern Any additions and extensions to existing fixed assets are also taken as capital expenditure Examples of such expenditures are · installation of new plant or machinery, cost of goodwill, cost of patents and copyrights etc Expenses incurred to make improvements in existing fixed assets permanently are taken as capital expenditures Some expenses like legal expenses, wages, carriage, stamp duty etc, also are taken as capital expenditures if they have been incurred in connection with the purchase or manufacture of fixed assets

Revenue Expenditures are those expenditures which are of recurring nature and incurred for carrying on day-to-day business of the concern or for maintenance of the fixed assets Examples of such expenses are expenses for purchasing goods for resale, cost of maintenance, repairs etc of the fixed assets, distributive expenses like commission, advertisement, establishment expenses like wages, salaries, rents etc, loss resulting from wear and tear and obsolesence or interest on loans taken from the business

Certain expenses incurred in a business concern are of such a nature which cannot be properly and clearly allocated between

capital and revenue For example, the expenses incurred together for repairs and replacement and renewal and extension of fixed assets, or expenses incurred on old works being pulled down and reinstated by new works of greater capacity, or existing plant to be discarded and replaced by one newly invented costly but more efficient plants In such cases, some arbitary method of allocation has to be resorted to or conventions in similar cases in the similar business in use have to be adopted The usual procedure is to capitalise the entire present cost of the new asset, and to charge off to revenue the book value of the old asset or present value of the old asset plus the cost of dismantling less the proceeds from the sale of old materials and value of old materials utilised in new constructions

The importance of the distinction between capital and revenue expenditures lies in that all the revenue expenses have to be charged to the Profit and Loss Account and all the items of capital expenditure are to be shown in the Balance Sheet [1] The final Accounts will be materially affected if they are not correctly dealt with

The auditor's duty is to be vigilant and careful so that the revenue expenses are not taken as capital expenses and vice-versa It is an essential part of his duty to make careful distinction between the two, following the fundamental principles of Accountancy If a revenue expenditure is wrongly capitalised and accounted as such, the Final Account will not show the correct picture It will inflate the profit to the extent and will also result in payment of dividend out of capital and over-valuation of the arsets On the other hand, if the capital expenditure is accounted as revenue one, it will unduly burden the Profit and Loss Account and deflate the profits of the concern It may result into creation of secret reserve too The Balance Sheet also will give a wrong picture as the value of the assets shown will be less than actual The auditor has to be careful in respect of those expenses which may appear to be revenue expenses on the face but may be capital expenditure in fact Such expenses are, for instance, wages, repairs, advertisements, legal expenses etc The test of their being capital expenditure is whether (*i*) they are spent for acquiring fixed assets, (*ii*) or they increase the earning capacity of the existing assets, (*iii*) or they tend to extend or improve existing assets

The auditor can perform his duty well in this connection if he is well-versed not only in accounting principles but also with the special circumstances, nature and working systems of the client concerned. However, the task is difficult as no general or hard and fast rules can be laid down as to be classification of expenditures between capital and revenue To be sure, he should obtain a certificate to that effect from some responsible official or the client himself If necessary, he may bring the fact into his report also, specially

1 Taylor and Perry, *Principles of Auditing*, p 206.

when the amount involved is large. But he must see that only proper allocation has been made

Deferred Revenue Expenditures

Sometimes the business concerns incur huge expenditures not for the purchase of fixed assets which are by way of capital expenses but for advertisements etc which are of a revenue nature These are known as deferred revenue expenditures and are incurred in lump sum, the benefits of which extend beyond the financial year in which they are incurred Since its benefits do not exhaust during that period but may be derived in subsequent years also, the whole amount incurred for such expenses is not charged to the Profit and Loss Account of one year alone It is usually carried forward and written off over the number of years for which its benefits may be anticipated by the concern In this way, the whole burden of such expenditures on the Profit and Loss Account is equitably spread over a number of years

The usual instances of Deferred Revenue Expenditures may be noted below

(*a*) Cost of removal of the business to a more convenient locality

(*b*) Cost incurred for dismantling, removing and re-erecting of plant and machinery

(*c*) Expenses incurred by way of exceptional repair of non-recurring nature

(*d*) Abnormal advertisement expenses incurred for heavy sale campaign

(*e*) Experimental expenditures

(*f*) Expenditures incurred on business researches

(*g*) Preliminary expenses in connection with the establishment of a new concern

(*h*) Development Expenditures

All such expenses involving huge amounts should not be charged to the Profit and Loss Account of the year in which they have been incurred It will reduce the profit for that year if the whole amount is charged in one year For example, the abnormal expenses on advertisement may be incurred to introduce a new commodity in the market It should be written off the Profit and Loss Account over a number of years, say, five years The Profit and Loss Account should be debited with the amount to be written off every year and the balance should be shown as asset in the Balance Sheet A prudent policy will be to write off such expenses as early as possible.

The auditor's duty in this connection is to see that only genuine deferred revenue expenses are written off over a number of years He should guard against the writing off of illegitimate expenses over a number of years just to inflate the profit of the concern The policies of the client in respect of the amortisation of deferred and pre-paid items should be discussed and understood fully Its calculations must always be checked and all the related vouchers must be examined to ascertain correct amount to be amortised. He should see that expenses have been correctly and properly spread over a number of years and debited to the Profit and Loss Account He should be careful to see that the balance of such expenditures not written off is shown on the asset side of the Balance Sheet until it is entirely written off

Total Accounts and Sectional Balancing

The Total Debtors' and Creditors' Accounts are maintained in a big concern where large number of transactions take place In such concerns, balancing of books involves considerable difficulty and it is not easy to prove the accuracy of balances of the Purchases and Sales Ledgers respectively The Total Debtors Accounts will contain the total of all items posted in detail to the debit and credit of Sales Leger, and the Total Creditors Accounts will contain the totals of all items posted to the debit and credit of the Purchases Ledger. The balances on the Total Debtors and Total Creditors Accounts at the end of the period should tally with the total of individual debit balances on the Sales Ledger and credit balance on the Purchases Ledger respectively If there is any difference it means that either the Total Debtors and Creditors Accounts are incorrect or there is some error in the Sales Ledger and Purchases Ledger

If the business assumes even greater magnitude, further check would be necessitated To cope with this, *Sectional Balancing* may be adopted to affect the balancing accurately and promptly Its features are as fallows

(*i*) The General Ledger contains all the accounts except the accounts of creditors and debtors Separate accounts of creditors and debtors are maintained in the Purchases and Sales Ledgers respectively.

(*ii*) In the General Ledger, Total Debtors and Total Creditars Accounts are kept for Sales Ledger, Purchases Ledgers respectively

(*iii*) The postings in total Debtors and Creditors Accounts are made in total

(*iv*) Separate columns for each Ledger may be provided in the Cash Book and other Books of prime entry But this method would not be practicable if the number of Ledgers exceeds three or four The alternative approach is to analyse these Books at the end of each

month to find out the total of items for each Ledger A summary thereof should be prepared which should agree with the total of the books of prime entry

The above system is of great use for a large concern, as it does away with the problem of balancing of a large number of accounts It ensures proper check also and errors can be located without much difficulty

It also facilitates the auditor's work to a large extent It ensures automatic checking of the arithmetical accuracy of trade ledgers and it will not be necessary for the auditor to carry on detailed checking of personal ledgers He may adopt test-checking of the postings of the books of original entry and verify the balances of total accounts with the totals of individual balances shown in Sales and Purchases Ledgers He should, however, take care about the amount of provisions made for bad and doubtful debts

LOOSE-LEAF LEDGERS

Loose leaf Ledgers or the Perpetual Ledgers are commonly used now in modern business concerns Their wide use bears the testimony that they have certain advantages over the bound books.

The chief advantage is that there is no use of opening new ledgers altogether at any one time as the ledgers are continuous, permanent and flexible Additional pages can be inserted as and when required with greater case and the Ledger is not burdened with unnecessary blank leave Sheets can be arranged or rearranged or subdivided according to need

All the leaves related to a particular account can be kept together The closed and dead accounts need not be maintained with other accounts They can be withdrawn and filed separately, avoiding the maintenance of a large number of accounts in the current ledgers It would also be helpful for reference purposes It facilitates division of labour also as the different functions like balancing, preparation of statements, castings and checking of sheets etc , can be allocated among a number of clerks

The system of loose-leaf Ledger possesses certain inherent defects also over the bound books The main defect is that there are chances of sheets being accidentally lost or destroyed The chances of committing fraud also exist The sheets can be substituted fraudulently with a view to conceal defalactions For similar reasons, the sheets may be intentionally destroyed also But these defects may be guarded against by employing the following measures of control

(i) There should be proper supervision so that sheets may not be accidentally lost or destroyed

(*ii*) The unused sheets should be kept under the sole custody of some responsible official who should keep them locked

(*iii*) The sheets should be specially designed or printed to avoid substitution by purchasing similar sheets from the market

(*iv*) Withdrawal of any sheet out of any Ledger should not be allowed unless duly authorised by a responsible official All the withdrawn sheets should be initialled by him before they are filed

While vouching Loose-Leaf Ledger, the auditor has to follow the procedures already outlined in the previous pages But he should take care that all the accounts have been duly vouched and that no sheet has been destroyed or substituted fraudulently

QUESTIONS

1 How would you, as an auditor, vouch (a) Purchase Ledgers, and (b) Sales Ledger

2 How would you undertake vouching of the Debtors' Ledger? What special points should be kept in mind while scrutinising the schedule of bad and doubtful debts?

3 How would you, as an auditor, vouch the outstanding assets and liabilities?

4 What are contingent liabilities? How should they be audited?

5 What do you understand by the 'Deferred revenue expenses?' How would you audit it?

6 What points should be kept in mind by the auditor while making distinction between the revenue and capital expenses.

7 What do you understand by the Total Accounts and Sectional Balancing? How would you audit the same?

8 What are Loose Leaf Ledgers? Discuss their advantages and limitations How should their defects be removed?

9 How would you audit the following

(a) Accrued income

(b) Audit fees outstanding

(c) Rent receivables

(d) Advertising expenses

(e) Pre-paid insurance.

10

Verification of Assets and Liabilities

The examination of the books of account with a view to ascertain their arithmetical accuracy is not enough The auditor must verify that the various items appearing in the Balance Sheet are in the possession of the concern under audit Verification is a process by which the auditor satisfies himself, by actual inspection or otherwise, as to the existence, ownership, valuation and accuracy of the various items appearing in the Balance Sheet *It may be noted that verification includes valuation* But for the sake of clarity, we have studied them in separate chapters

The scope of verification is not the same as that of vouching and the distinction between the two must be clearly understood [1] The vouching of books would only tell that a particular assest ought to exist but it cannot prove whether that asset really exists or is in the possession of the concern at the date of the Balance Sheet It may be possible that the asset might have been purchased but later on sold out, lost, destroyed, pledged or misappropriated Therefore, their verification becomes necessary

Spicer and Pegler have defined verification in the following words "The verification of assets implies an enquiry into the value, ownership and title, existence and possession, the presence of any charge on the assets" Thus, according to them, the verification refers to the examination of value, ownership, existence etc It also involves finding out whether the assets are free from any charge or not

In the words of *Lancaster*, "The verification of assets is a process by which the auditor substantiates the accuracy of the right-hand side of the Balance Sheet, and must be considered as having three distinct objects (a) the verification of the existence of the assets, the valuation of assets and (c) the authority of their acquisition" Thus, according to him, verification is a 'process' It involves substantiating the accuracy of the various assets shown in the balance sheet He has also made the objects of verification very clear

1 Taylor and Perry, *Principles of Auditing*, p 82

In both the definitions, it may be clearly seen that the verification is a broader term and includes valuation of the assets At the same time, it may also be seen that the definitions refer to the verification of the assets only, but the verification of the liabilities is also quite important and necessary.

While verifying the various assets the auditor has to examine the following points

(i) The assets, in reality, exist at the date of the Balance Sheet.

(ii) They have been acquired for the business and clearly stated in the Balance Sheet

(iii) Values of the assets shown in the Balance Sheet are correctly and properly ascertained.

(iv) Ownership in the assets lies with the concern

(v) The assets are free from any charge or lien

To verify the existence of the assets, the auditor should, as far as possible and practicable, inspect them on the date of the Balance Sheet It should be done specially with regard to the verification of current assets which are continually changing The auditor has to carry on verification with extreme caution, so that fraudulent manipulation may be avoided or detected It is very simple to present the same set of securities or the balances of cash in hand twice to make up the deficiency if reasonable care is not exercised by him The auditor should press for the presentation of all the securities or all the balances of cash etc at one time to avoid the possibility of substitution As the examination may spread over several days, he must keep all the documents not examined under his control and possession until he has completed his examination He should also be careful not to take any assistance from the client's staff for the purpose of actual verification of such assets

He must see that all the assets are free from any charge or lien; and if they are not, it has been clearly stated in the Balance Sheet To check this, the documents of title should be examined Even if these documents of title have been deposited with the bankers, solicitors or any other party, the auditor should try to inspect them He should also obtain a certificate from the holders to the effect that they do possess documents free from any charge or otherwise.

Let us explain the *difference between 'Confirmation' and physical verification'* The term 'verification' has already been explained and, in fact, includes confirmation However, confirmation implies those techniques adopted by an auditor by which he affirms certain facts or balances from certain competent parties The competent party may be any third party or the management itself He may get such confirmation from the debtors, creditors, bankers, other financial institutions, company brokers or legal advisers etc. regading certain assets

' the company, which may be in their possession with or without iarge Sometimes, the confirmation may also be required from the anagement itself. For instance, if there is any contingent liability, ie auditor may require their confirmation from the management self

We now study how the various assets of a business concern can e verified

Land and Building The auditor should examine the title eeds, if the land and building are freehold, to ensure that they are i the name of the client The title deeds should cover all the land nd buildings shown in the books of account He should obtain a ertificate from the client's legal adviser confirming the validity of the itle of the client to the property, if necessary, as he may not have dequate legal knowledge Any addition or sale, during the year hould be carefully examined In case of sale, he should see that any rofit or loss thereon has been adjusted properly in the accounts

If the property is mortgaged, he should obtain a certificate from he mortgagees or their solicitor to the effect that the title deeds are n their possession He should also make enquiry to find out that here is no second or subsequent mortgage

In case the building is under construction, he should verify its lebit balance with the help of the architect's certificates as well as the ontractor's receipts for the amount paid therefor If the client's own staff is also engaged in its construction, the auditor should see hat a reasonable basis of allocation of cost of material, wages, supervision charges etc has been adopted To be safe, he should obtain a certificate from a responsible official to that effect

He should see that if some expenses have been incurred with a view to increase its earning capacity, that should not be charged to Profit and Loss Account and be capitalised

In case of the leasehold land and buildings, the auditor should inspect the lease or its assignment He should ascertain the amount of premium paid for it He should see that the premium paid to acquire the lease and legal expenses incurred for acquiring it should be capitalised, but no revenue expenditure should be debited to this account or capitalised He should also see the terms and conditions of the lease, e g prompt payment of ground rent, insurance of property, repairs etc and find out whether these conditions have been complied with or not If a part of the leasehold property has been sub let, the auditor should see that counterpart of the tenant's agreement In case there is a dilapidation clause in the lease, he should enquire whether the claims have been made on the expiry of the lease

As far as possible, land and building should be shown separately in the Balance Sheet since building is subject to depreciation

whereas land is not To verify the sale proceeds of different plots of land, he should inspect the certified copies of sale deeds executed

Plant and Machinery The verification of plant and machinery by actual inspection is not always possible and practicable Wherever it is feasible, the auditor should inspect and see some of the main plants by a visit to the factory Otherwise in the process of vouching he may satisfy himself of their existence Authorisation and voucher for the purchase of machinery are already examined while vouching the accounts The auditor should be certain that the plant and machinery account balances at the beginning and at the end of the period agree with the Balance Sheet amounts It is advisable to maintain a Plant Register containing the particulars about each plant and machinery in detail If it is not maintained, the auditor should obtain a schedule of plant and machinery certified by the engineer

Any addition to or sale of machinery during the year should be carefully verified with the help of invoices, contracts or receipts etc. If the machinery is manufactured by the client for his own use, verification is made of the material, labour and overhead charges taken to Machinery Account The expenses by way of installation should be capitalised Reinstallation cost should not be capitalised, unless it results into increasing its earning capacity The items of repairs or replacements should not be wrongly capitalised. The profit and loss on the sale of machinery should be properly dealt with in the accounts Any deduction made from it during the year should be carefully examined and the auditor should see that such deductions are proper

Furniture, Fittings and Fixtures They may be verified with the help of invoices obtained from the supplier as personal inspection may not always be possible Any expenditure incurred for obtaining them should be capitalised For example, the freight and carriage spent on bringing the furniture to the shop or the factory should be charged to the Furniture Account and should not be transferred to the Profit and Loss Account Any addition or sales during the year should be carefully scrutinised and it should be seen that only genuine additions or deductions have been made in the accounts He should see that proper control has been applied to safeguard against their pilferage If Stock Register has been maintained containing all the particulars in detail, he should inspect it At the close of the period an inventory should be prepared and compared with the Stock Register

Small Tools The verification of small or loose tools by personal inspection is rather a difficult job, and in some business concerns such assets are purchased and used in a very large quantity They have low life and low unit of cost It is desirable that yearly inventory of such tools should be prepared to check the stolen tools,

d those of improper quality Special note should be taken for ch tools which may be of no use to the concern in future

Motor Lorries and Vans These assets should be verified with e help of the invoices from the suppliers Permits and Registration ook should be examined to verify ownership Vehicles should be rsonally inspected checking the registration number Any addi- on made during the year should be scrutinised Scrapping of the hicles should be carefully examined and the auditor should see that was done only when it was authorised by a reasonable person

Patterns and Drawings Usually the amount spent on patterns id drawings is charged to revenue, but it considerable amount is vested in these assets they may be temporarily capitalised But if ey are capitalised, relevant voucher should be consulted by the iditor to verify them

Patents, Trade Marks and Copyrights These assets should be erified with the help of the documents granting patents, trade marks copyrights Any agreement entered into should be properly rutinised He should see the last renewal receipt for them to ascer- in that the right with the client is legally enforceable The auditor iould see that renewal fees have been charged to revenue He iould insist for a schedule of all the patents, trade marks and copy- ghts duly certified by a reasonable official

Livestock The auditor should obtain a schedule of livestock uly certified by some responsible official and verify it with the egister of Animals, if any Any addition by way of purchase or ew births should be included, but those animals which have been old out or have died should be excluded from the schedule.

Ships They should be verified with reference to the Bill of ale, or the agreement with the ship builder if built to order Their wnership may be ascertained with the help of certified copy of the ntry in the Port of Registration or endorsement on the back of the ill of Sale The copy of 'entry' should be examined to ascertain iortgage, if any

Assets acquired under Hire Purchase and Instalment Agreement 'o verify such assets, the agreements should be carefully examined 'he auditor must see that the Asset Account has been debited only vith the amount paid by way of cash value of the asset till the date of he Balance Sheet He should see that the amount of interest included i the instalment values has been charged to revenue account and ot debited to the asset account In case the asset account has been ebited at the outset with the total cash purchase price, he should ee that the total amount of the instalment due under the agreement n the date of the Balance Sheet has been either shown as liability or leducted from the value of the asset.

Assets Abroad The auditor should obtain a certificate duly certified and signed by the local agent or other party holding the assets abroad The document of title of such assets should be inspected In case those documents are in the possession of some other party, a certificate should be obtained He should ascertain with the help of the certificate that such assets are free from any charge Any discrepancy in this regard should be disclosed in the report

Stock-in-trade The correct recording and auditing of stock or inventories is of paramount importance It forms an important part of an auditor's duty to verify it carefully. The client encounters maximum difficulty in arriving at a reasonable inventory figure and the auditor has equal difficulty in satisfying himself that the client's figure is reasonable

Being one of the largest current assets of a concern, the stock exerts considerable influence over the profit or loss of a concern If the inventory is incorrectly recorded, counted or evaluated, the resultant profit or loss for the period will be incorrect It will also affect the Balance Sheet and the assets and net worth will present a wrong picture Coupled with it is the fact that it offers maximum opportunities for intentional or unintentional errors which may have material affect upon the profit It has been found in practice that concerns go on overstating the value of inventory constantly and knowingly and thus sharing enough profit when in reality they were bankrupts

Walter B Meigs[1] has listed the following *six reasons for special significance attached to the verification of inventories*

(*i*) Inventories usually constitute the largest current asset of an enterprise

(*ii*) Numerous alternative bases and methods of their valuation have received the sanction of the accounting profession and of regulatory agencies of the government

(*iii*) The determination of inventory values directly affects the cost of sales and hence the income for the year

(*iv*) Inventories are more susceptible to major errors and to manipulation than any other asset category

(*v*) The rapidly changing price levels of recent years have drawn attention to inconsistencies and inadequacies in conventional methods of accounting for inventories.

(*vi*) The verification of inventory quality, condition, and value is inherently a more complex and difficult task than is the verification of most elements of financial conditions

1. *Principles of Auditing*, p. 322.

It has been held that the auditor has not actually to count the ɩventory or even supervise its counting This has to be done by the ıent or the management It is no part of his duty to do this [e has to ascertain the fairness of the client's inventory figure His ɜsponsibilities begin, after it has been already counted and evaluated y the client The responsibilities may be with regard to the clerical ccuracy, quantity in hand at a certain date, general quality and cor-ɜct pricing As he cannot be expected to be an expert possessing all he technical knowledge, he may rely upon the statements, reports, r certificates given to him in this respect But before accepting this, e must satisfy himself whether it is correct or not, applying certain easonable tests The slightest doubt with regard to its correctness hould make him pursue the matter in detail until everything is clear ʿhe auditor should bear in mind that in its verification, an analytical tudy of conditions and their causes and effects count far more than nechanical checking He should apply his ability, discretion and ·xperience in the broad perspective to satisfy himself as to its accu-acy and fairness. He should have enough knowledge about the nerchandise or manufacturing processes so that he may satisfy him-ɹelf, as far as possible, about the existence of the inventory and the ɩccuracy of the inventory quantities

The precise duties of an auditor with regard to the verification of inventories are not very clearly defined Disputes have arisen in the past in this respect and the accountants also hold different views. Some are of the opinion that the auditor should carefully ascertain the accuracy of inventories and satisfy himself as to their correctness Others hold that the auditor is not competent enough to do so and he may rely upon the certificate given to him by the management, provided he applied certain tests to check its accuracy

The British Courts have held that the auditor will not be liable if he relies upon the inventory certificate from the client In the case of Kingston Cotton Mills Co Ltd , (1896) , it was held that "it was no part of an auditor's duty to take stock" and that "he must rely on other people for the details of the stock-in-trade in hand". It was further held that the omission of the auditor to check the accuracy of the figures certified by the manager was not a breach of duty. He is "Justified in believing tried servants of the company He is entitled to assume that they are honest and to rely upon their representations provided he takes reasonable care " But now the accountants there too have expressed doubts over this They feel that the principle laid down as long back as 1895 in *re Kingston Cotton Mills Co Ltd* should be adjusted according to the changed circumstances

In a recent decision of the Court of Chancery Division in England, *re Thomas Gerrard & Sons Ltd* (1967), Pennycuick, J , after a review of previous authorities and considering the expert evidence of experienced and reputed accountants given before him, has stated that in the case of company auditors "the standards of reasonable

care and skill are, on the expert evidence, more exacting today than those which prevailed in 1896", when the leading case of Kingston Cotton Mill Co was decided by the Court of Appeal The main question in this case was whether, when in the course of verifying stock the auditors noticed some alterations in the invoices, which might affect the value of stock at the end of accounting period and on their questioning the managing director (who was then a well-known and respectable figure in the district and justice of peace) and also the secretary of company gave some explanation and assurances as to the stock-taking procedure, the auditors could simply accept such explanation and assurances and desist further enquiry

In the view of the learned Judge, the altered invoices put the auditors on enquiry on the expert evidence and as a matter of business commonsense they were not entitled to rest content with what the managing director and secretary had said It was pointed out that though it was no part of their duty to take stock, it was certainly incumbent on them, when once material alterations affecting valuation came to their notice, to take all reasonable steps to verifty that the supporting vouchers and records relating to the taking of stock were in order.

The Institute of Chartered Accountants in England and Wales is of the view, as in India, that an auditor is not required to undertake a complete physical examination of stocks However, it has been pointed out that "if it is practicable and if stock-in trade and work in progress is a material factor in the business, the auditors should satisfy themselves as to the effectiveness of the application of the client's stock taking procedures while the stock taking is in progress"

Recent legislation and custom in the United States have placed greater responsibilities upon the auditors in this connection They have now decided to make physical contact with the inventories presented to them after the decision in the *Mckesson and Robbins* case involving fraud amounting to 21,000,000 dollars It turned to be a milestone in the history of auditing in the United States of America

The Security and Exchange Commission in U S A investigated into the matter and reported, "Auditors should gain physical contact with the inventory either by test counts, by observation of the inventory taking or by a combination of these methods" The American Institute of Certified Public Accountants observed "To satisfy himself that the counting of the inventory is done carefully and also to gain general familiarity with the inventory, the CPA is required by generally accepted auditing practice to be present at the inventory taking to observe the effectiveness of the count procedures when it is practicable and reasonable to do so and the amount of the inventory is significant."

In India, the position is same, as in U K, mentioned above The Institute of Chartered Accountants of India has stated that it is

not the duty of an auditor to undertake physical count of inventories, as he lacks technical knowledge in this connection He should, however, "enquire into the methods and procedures of verification followed by the management and test the competence with which these procedures are carried out"

While verifying the stock, the recent changes made in the Companies Act, 1956 should also be kept in mind It has extended the responsibilities of an auditor in this context It requires the maintenance of proper books of account, by a company, which must include books kept to record transactions in stock-in-trade (section 209) 'Proper books of account' have been defined in such a manner as to include statements of annual stock-taking and (except in case of good sold by way of ordinary retail trade) of all goods sold and purchased (section 541) The figures of opening and closing balances of stock and work-in-progress should be disclosed in the Profit and Loss Account (Part II of Schedule VI)

Before actual verification of stock the auditor should enquire about and be familiar with the time of taking inventories He should seek opportunities, to offer advice with regard to adoption of the 'natural business year' Most of the business concerns, specially seasonal ones, have a natural business year at the end of which the production is slow and the inventories are low If the natural business year is chosen as the financial year, the inventory problem is greatly simplified, It is because the stock is lowest and more personal will be available for work In case the perpetual inventory records are maintained, the physical inventory should be taken at least once to check the accuracy This method is more suitable for a manufacturing concern rather than a mercantile concern

It may be suggested that a good plan to follow in this context would be to make an arrangement with the client The auditor should review beforehand the client's programme for the physical inventory He should offer to his client at this juncture for improving details in the programme Suggestions should be such which may provide maximum assurance that the final figures will be sufficiently reliable The next step is to apply reasonable test to satisfy himself that the programme has been carefully followed But this must be done at all the stages of taking and compiling of the inventory If he follows this plan, he may accept the final figure of the inventory as reasonably satisfactory

The auditor should, thus, proceed for the verification of stock in the following manner

(i) He should review and be familiar with the procedure and arrangements for the maintenance of stock records and find out any discrepancy therein

(ii) He should examine how effectively the management controls the receipts and issues of stock and physical stock-taking He

should also obtain inventory instructions to ascertain the methods of stock-taking and find out whether complete or partial physical stock-taking has been carried out

(iii) He should compare the rough original stock-sheets with the fair copies, noting any material alterations therein which should be carefully enquired into He should, then, test some of the items of the stock with the stock records with regard to quantity and values Material difference, if any, must be enquired into

(iv) He should test the prices of various items of stock with the help of catalogues, quotations, current sales invoices or price lists ets

(v) He should check carefully the casts and extensions of some important items.

(vi) He should examine and find out that no goods which do not belong to the client (e g goods sold to customers before the date of the Balance Sheet, goods received on consignment, sales or return basis ets) have be included in the stock He may check this with the help of the Sales Book and Goods Outwards Book Similarly, all the goods purchased during the year and belonging to the client, though not in his possession, should be included in the stock All the stock lying for sale at ports, warehouses, with agents or with the customers on approval should be included in the stock He should also see by comparing the previous year's stock sheet, that all old and obsolete stocks have not been included in the stock and have been written off

(vii) He should examine that no fixed assets such as plant, loose tools, furniture, motor cars etc, have been included in the stock and only goods normally dealt with in the business have been included

(viii) He should calculate the percentage of gross profit to the turnover of the previous year as well as the current year If he finds wide fluctuations on comparison, he should enquire into the matter in detail

(ix) He should obtain a certificate with regard to general accuracy of stock sheet and its valuation from a senior official Such certificate may be in the following form

> "I hereby certify that the above is a correct inventory (containing in all pages or sheets) of stock-in-trade as on 19 valued at Rs

(1) All the quantities were determined by actual count, weight or measurement.

(2) The entire stock has been uniformly valued at lower than the cost or market price, and adequate provision has been made for old, spoiled and obsolete goods.

(3) The stock included in the inventory was the property of the concern which is unencumbered and does not include any stock held on consignment from others

(4) The above inventory includes all the goods of any kind which were the property of the company wherever situated, but no stocks in respect of which cost has not been entered in the books or goods sold, which either have not been delivered to the customer or have been returned by him Also it does not include any plant, equipments, loose tools, furniture and fixtures, or other similar assets, the cost of which has been similarly charged in the books

Qualities taken by signed
Values fixed by . at
Additions, calculations, and extensions by .
Checked by .
Finally approved by

Managing Director

(x) He should carry on verification of values of stock as outlined in the next chapter

Book debts Verification of the book debts involves detailed checking of the schedule of all the debtors with the Ledger and statement of accounts directly received from the debtors It has already been discussed in detail in subsequent chapter

The auditor should examine that the provisions of the Companies Act, 1956 have also been duly complied with The Act requires that a distinction should be made between the debts considered good and those considered doubtful All the companies must also disclose the secured and unsecured debts separately It requires the debts to be classified and shown as below

(i) Debts considered good in respect of which the company is fully secured

(ii) Debts considered good for which the company holds no security other than the debtor's personal security.

(iii) Debts considered doubtful or bad.

It further requires that the debts due by the directors or other officers of the company either severally or jointly with any other persons should be shown separately Debts due from other companies under the same management should be disclosed with the names of the companies The auditor should be careful and see that these provisions have been duly followed

The best method to verify the book debts is to obtain the confirmation regarding outstanding balances directly from the debtors The confirmatory letter should be signed by the client requesting the customers to confirm the balances directly to the

auditor The institute has also suggested a draft for such letter For reply, a stamped envelope with the address of the auditor should be enclosed On receipt of such letter, the auditor should verify the same carefully At the same time, he should seek confirmation from a responsible official of the enterprise also regarding their balances and classification

Loans The auditor should verify them with the help of loan agreements and acknowledgements by the respective parties of such outstanding loans If the loans are secured, the securities should be inspected by him If not secured, he should ascertain facts about their recovery He should find out whether loans advanced were within the powers of those who did it

These loans should be shown separately and not included in the debts due from sundry debtors They should be shown and classified in the Balance Sheet as in the case of Book Debts discussed above Special care should be taken in examining that loans advanced to the directors or officers of the company are shown clearly and separately in the Balance Sheet.

Advances The auditor should obtain a list of all the advance payments and check it with the Ledger If advances were made under some agreement, it should be inspected Provisions for irrecoverable advances, if any, should also be made If the advances have been made to the subsidiary companies, that should be shown separately The Companies Act, 1956 requires that those debts which remain unrealised for a period of three months from the date on which the debt in respect thereof arose are to be treated as loans or advances and should be separately shown under the head 'Loans and advances' They should also be shown and classified in the Balance Sheet as discussed above

Investments. The auditor should verify them by inspecting the securities such as shares, certificates or scrips, Government loans, bonds or notes and debentures etc If the securitins are lodged with the bankers or third parties, he most obtain a certificate from them to ascertain the charge or lien existing on the securities If there are many investments, the auditor should insist for a schedule of all the investments held on the date of the Balance Sheet It must mention the names, cost, market value on the date, book value, rate of interest, dates of payment of interest etc The auditors should verify the details of the schedule by applying certain tests *e g* , financial journals should be consulted for checking the market rates , the securities themselves may be consulted or the brokers' notes etc , may be examined for checking the cost. In case the investments have been acquired as a result of underwriting contracts, their cost should be the amount subscribed less the underwriting commission received

The auditor should verify the amount of interest or dividends etc., accrued on investments. Only those dividends which have already

been declared before the date of the Balance Sheet should be taken into account as outstanding ones He must verify with relevant accounts that all income from investments has been collected and recorded [1]

Inspection of securities for the verification of investments has been clearly emphasised in *re City Equitble Insurance Co Ltd* in the following words "For an auditor is not in my judgement ever justified in omitting to make personal inspection of the securities that are in the custody of a person or company with whom it is not proper that they should be left Whenever such personal inspection is practicable, and whenever an auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter be put right at once, or, if his requirement be not complied with, to report the fact to the shareholders"

We have an Indian decision—*Re G M Oka*—where the auditor was found guilty of having issued a false and misleading certificate without actually verifying the investment on that date

Section 49 of the Companies Act, 1965 requires that all the investments made by a company on its own behalf should be made and held by it in its own name, and where any such investments are not held at the commencement of the Act, the company shall within a period of one year from such commencement either cause them to be transferred to, and hold them in its own name or dispose them of.

He should examine the register of investments under section 372 (6) of the Companies Act, 1956 to obtain information regarding investment in companies in the same group

The auditor should see that provisions of Sections 49, 77, 292, 293 (c) and 372 of Companies Act, 1956 have been duly complied with Part I Schedule VI of the Act requires the investments to be shown in the Balance Sheet in a prescribed manner making distinction between (*i*) investment in government or trust securities, (*ii*) investments in shares, debentures or bonds, and (*iii*) immovable properties The nature of investments and the mode of valuation have also to be disclosed.

Cash in Hand The auditor should verify the cash in hand by actually counting it on the date of the Balance Sheet If actual counting is not possible, *e g*, in case of cash at branches and cash with the agents, the respective documentary evidences should be carefully examined A fundamental aspect of its verification is the *time* when it should be verified The verification should be made at the close of the business or on the date of the Balance Sheet or the following day. Besides, there should be a surprise check on some subsequent date to ensure its accuracy

1. Walter B Meigs, *Principles of Auditing* p, 240

The auditor should enquire into the different balances of cash in hand maintained at different counters which have to be verified He should check all the cash balances, if there are many, simultaneously as far as practicable to avoid any substitution This is necessary so that shortage in one balance may be not be made good by transfer from the others After counting the known funds, if the auditor comes to know that there is another fund which is held by the same cashier, he should not hesitate to make a second count of the former also The auditor should insist upon the presence of the cashier to witness the counting It is quite necessary so that the auditor may not be blamed for shortage, if any In practice, attempts have been made in the past to hold the auditor responsible for shortage in cash

De Paula suggests "A very good plan is to arrange that all cash balances at the close of the financial period shall be paid into the bank upon the last date of such period, cheques being drawn upon the following day to reopen the cash accounts In this way all cash balances are automatically counted and accounted for, and the auditor is thus saved from a somewhat invidious task "[1] This is a good plan indeed, specially when the auditor is unable to check the balances on the date of the Balance Sheet.

In general, large cash balances should not be allowed to stand and if there is any tendency for cash balances to increase, it should be brought to the notice of the client

In case, the auditor finds the I O U. slips etc for temporary advances made to the employees, he should verify them carefully He should enquire in detail about their genuineness and get them initialled by some responsible official

In general, the auditor should try to count all cash But it is impracticable in the case of Bank In such case notes and cheques should be counted and bags of gold should be weighed Bags of coins should also be weighed, testing some of them by opening and counting. A list may be prepared inserting all the details of funds. *He should undertake at least one surprise verification every year*

It should be noted that it is an important part of an auditor's duty to verify cash in hand by actual counting or otherwise, whenever actual counting may not be possible He should not rely much upon the certificate in that respect as it will not absolve him from his responsibilities

He should verify carefully the petty cash balances If he is negligent to do so, he may be held liable for the same In *London Oil Storage Co , Ltd v Sear Hasluck & Co* the auditor had omitted to verify the existence of a sum of £ 796 shown in the Balance Sheet as petty cash in hand In fact, the balance in hand was only £ 30

1 *The Principles of Auditing*, p 85.

and the difference had been misappropriated by the secretary who kept the Petty Cash Book

Cash at Bank It should be verified by reference to Bank Reconciliation Statement and a certificate with regard to bank balances received direct from the bank by the auditor In case the bank balances are not verified on the date of the Balance Sheet but long after that, the auditor should reconcile the bank balances right up to the date on which he is verifying them The Bank Reconciliation Statement should be very carefully examined. He should guard against the presentation of a fictitious statement Its genuineness may be found out by comparing it with the bank's certificate If the two do not tally, the auditor should examine it in detail and see whether there are any uncleared items included in it, which must be duly verified To check the possibility of fraud, the last few days' deposits into the bank should be subjected to special scrutiny He may satisfy himself that Pass Book credits in respect of bills discounted have not been entered in the Cash Book as ordinary receipts from the customers This may be verified with the actual inspection of the Bills Receivables in hand.

Goodwill Every prosperous concern expected to yield super-profits in future has a goodwill, but it is not usually brought to account It is, however, brought into account books only when it is purchased for valuable consideration

The auditor should examine the purchase agreement or the partnership deed to ascertain the cost of goodwill He should see that the goodwill has been brought in the books at a proper figure If it has not been fixed specifically it would be equal to the difference between the total purchase price and value of the assets taken less liabilities, taken over from the vendors He has to be careful in his examination and see that (*i*) no improper items have been added to it, and (*ii*) it has not been written up

VERIFICATION OF LIABILITIES

Verification of liabilities is as much important as that of assets. Overstatement or understatement of liabilities has considerable effects on the Final Accounts of a concern But the basic approach in both the cases differs The verification of most of the assets is based on personal opinion guided by sound judgment and well establised practices Hence, "The asset side of a balance sheet is an expression of opinion when considered as totality" But same is not the case with the liabilities They are not statements of opinion but statements of fact in most of the cases The contingent liability is however, exception to this as it is only an estimate, but it is not included with other liabilities The question of valuation of liabilities does not arise as exact amount of responsibilities can be determined [1]

1. Taylor and Perry, *Principles of Auditing*, p. 133

The main duty of an auditor in this respect is to see that all the liabilities are included in the Balance Sheet at their correct amounts He should see that they are not overstated or understated or even deliberately omitted He should also obtain a certificate, from some responsible official as to their correctness The importance of verification of all the liabilities with due care by the auditor was emphasised well in *Re Westminster Road Construction Engineering Co Ltd* (1932)

Now we discuss the verification of various liabilities

Share Capital In case of a firm, the auditor should verify it with the help of Partnership Deed, Cash Book and the Pass Book He should see that it has been properly recorded in the books of account.

In case of a company, it should be verified exhaustively, particularly in the first audit The auditor should refer to the Memorandum of Association, Register of Members, Cash Book, Pass Book, Minute Book etc to verify it carefully He should see that the total paid up capital, calls in arrears, calls received in advance, amount paid on forfeited shares, premium on issue of shares etc, have been properly and correctly dealt with in the accounts The contract with the vendor should be properly examined if the shares have been issued to him by way of purchase considerations He should see that all relevant provisions of the Companies Act, 1956 have been fully observed In subsequent years, he will have simply to verify further calls made, transfers further issue of capital etc, if any

Debentures The auditor should refer to the Memorandum and Articles of Association to find out whether the company has got power to issue the debentures and that the limit, if any, has not been crossed. He should also keep in mind the provisions of section 293 (1) (d) of the Companies Act 1956 putting limitations on borrowing However, the provisions of this section may be relaxed by a resolution of the shareholders and the auditor should see if it has been done He should also obtain a copy of the debentures bond issued to see all the terms and conditions laid therein.

The debentures may be issued at par, at premium or at a discount If they have been issued at premium, the auditor should see how it has been dealt with in the accounts Such premium may not be utilised for distribution of dividends, unless there is some express provision in the Articles If they have been issued at discount, the debentures must be shown in the Balance Sheet at face value and such discounts should be written off as soon as possible If they have been issued at par but redeemable at premium, such loss should be charged from the Profit and Loss Account

In case redeemable debentures have been issued, the auditor should ascertain the terms of redemption He should see that all the

provisions are being duly complied with If an Insurance Policy has been taken for their redemption, he should verify that such policy has been duly assigned to the trustees for the debenture-holders If some profit is made on the redemption of the debentures that should be treated as capital profit

Trade Creditors The auditor should obtain a schedule of all the creditors The schedule should be compared and checked with the Purchase Ledger The balances in both should agree He would have already checked the Purchase Ledger while vouching it with the help of purchase invoices, credit notes, Goods Inwards Book, Goods Outwards Book etc The auditor may verify the cash payments made to creditors subsequent to the date of the Balance Sheet also to find out any discrepancy He has to satisfy himself with the help of the Goods Inwards Book that all the purchases during the year have been duly recorded in the books of account and there is no omission or suppression of invoices He should compare the percentages of gross profits earned with that of the previous year to trace the omission of invoices, if any If he so feels, he may obtain statements of account from the various creditors directly and then verify them carefully

Bills Payable The Bills Payable Book and the Bills Payable Account should be referred to by the auditor The outstanding bills of the date of the Balance Sheet may be verified by comparing the balance on the Bills Payable Account and the bills not shown in the Bills Payable Book The returned bills should be taken as evidence for the payment made for the mature bills The Cash Book for the period subsequent to the date of the Balance Sheet should be carefully examined to ascertain whether the payment for such bills has been made which was due on the date of the Balance Sheet and not shown therein If he feels necessary, he may call for letters of confirmation from the drawers of the bills and check the amount of unpaid bills

Loans Loans should be verified with the help of the agreements entered into or the correspondence with the lenders In case, the loans or the overdrafts have been taken from a bank, agreement with the bank and a certificate to the effect should be obtained and examined The auditor should see whether the interest due has been paid or not. If the interest is due but not paid till the date of the Balance Sheet that should be clearly shown as liability therein. Secured loans and unsecured loans should be shown separately with proper sub-divisions Mortgages, if any, should be clearly indicated in the Balance Sheet He should see, in case of a company, the Memorandum of Association and the Articles to examine its power of borrowing If loans have been secured by a charge or mortgage, the Register of Mortgage should be referred to He should also see that the charges have been registered with the Registrar.

Outstanding Expenses The auditor should see that all the expenses incurred during the year such as wages, salaries, rents and rates, commission, interest, discounts etc , have been duly taken into account The expenses which are due but not paid for are known as outstanding expenses which must be shown in the Balance Sheet as liabilities It has been already discussed in detail in an earlier chapter

Contingent Liabilities The auditor should verify these liabilities carefully These contingent liabilities may become actual liabilities on the happening of certain events in the future. For example, the contingent liability in respect of the bills discounted should be verified with the help of the Bills Receivable Book and a certificate from the bank in this respect may be asked, if necessary The auditor will have to take various factors into account for verifying the existence of such liabilities It is advisable that he should obtain a certificate from some responsible official to effect that such expected contingent liabilities have been brought into the accounts He should insist for making a provision in case it is expected that some of the contingent liabilities are to turn into actual liabilities resulting into a loss to the client It has been already discussed in detail in the previous chapter

The institute of Chartered Accountants in England and Wales issued a statement on ascertainment and confirmation of contingent liabilities arising from pending legal matters in August, 1970 It was mentioned that the auditor should verify it carefully and lend review the system of recording claims, bringing them before the management and the arrangements for giving instructions to the solicitor concerned He should examine the minutes of the Board's meeting, the bill of the solicitor and the correspondence with him. A list of such matters pending in the courts should be also obtained from responsible officer In India, our Institute is silent on this issue However, the auditor must confirm such liabilities very carefully

QUESTIONS

1 What do you understand by verification? Distinguish clearly between verification and valuation and explain the objects of verification

2. Write an essay on "verification of stock." Explain auditor's duty in this connection

3. How would you verify the following:

(a) Small tools ;

(b) Patents and copyrights ,

(c) Assets acquired under hire purchase ;

(d) Book debts, and

(e) Loans and advances

4 How would you, as an auditor of a company, verify the vestments

5 How would you verify (a) the cash in hand, (b) cash at ınk, and (c) goodwill

6 How would you verify the following liabilities

(a) Outstanding liabilities,

(b) Sundry creditors,

(c) Bills Payable,

(d) Loans, and

(e) Contingent liabilities

7 How would you verify the following:

(a) Patents,

(b) Freehold property,

(c) Trade marks,

(d) Investments, and

(e) Land and building

8 What do you understand by contingent liabilities? Give ree examples of such liabilities and explain as to how would you rify them?

9 What is verification? How does it differ from vouching? › an auditor, what would you do regarding verification?

10. "Verification of stock is a difficult proposition and is not free- ›m controversy" Explain it and discuss the duties of an auditor garding verification of stock

11. How would you verify the following

(a) Cash in hand,

(b) Livestock,

(c) Book debts, and

(d) Assets abroad

11

Valuation of Assets

Valuation forms an important part of every audit It is because the accuracy of Balance Sheet depends much upon how correctly the estimation of the value of various assets has been made Both over-valuation and under-valuation of assets would exhibit a wrong picture of the financial affairs of a concern For instance, if the various assets are shown in the Balance Sheet with the inflated value, say, by Rs 5,000, it would exhibit a better picture of the concern to that extent than what it actually is On the other hand, if the assets are under-valued, it would present a depressing situation of the concern Wrong valuation has its impact on Profit and Loss Account also and consequently it may increase or reduce the profit or loss of the concern

Meaning In Auditing, valuation does not imply the calculation or determination of values of various assets appearing in the Balance Sheet It implies the critical examination and testing of the determined values of assets by the auditor on the basis of generally accepted conventions and accounting principles) Thus, for the valuation of various assets the auditor has to take the following steps

(*i*) Obtain all the informations available in this respect

(*ii*) Examine and analyse all the figures critically.

(*iii*) Test the values of various assets which have been already determined by the management or proprietor of the concern

(*iv*) Ascertain that the values have been determined on the basis of generally accepted conventions and accounting principles

(*v*) Ascertain that the basis of valuation has been consistently followed from year to year If there is any change, he should seek proper explanation for it.

(*vi*) Seek assistance from the technical personnels, if necessary, for ascertaining the value of any particular asset.

(*vii*) He should, then, form his opinion with regard to the accuracy of the value of the assets

Accurate valuation of assets with mathematical precision is not possible in many cases The values at which most of the assets appear in the Balance Sheet are to be estimated and the estimated values need not be the correct values Of course, such estimates are made on the basis of the principles generally recognised as sound and correct and are bound to be more or less approximate

The *difference between the verification and valuation* should be clearly understood Verification has a broader implication and, in fact, it includes valuation Thus, valuation is a part of verification. It needs, however, careful consideration on the part of auditor, as it helps him to a large extent in forming an opinion regarding true and fair view of financial state of affairs

It is no part of an auditor's duty to determine the values of various assets It has been judicially held that *he is not a valuer* [1] The determination of values of the assets is to be made by the management, of course with the help of experts, as only they possess intimate and practical knowledge about such assets as well as the nature of the business concern and, therefore, they are more competent to do this An auditor is not expected to possess the necessary technical knowledge and he has only to test the determined values

It is to be noted here that a Balance Sheet is a statement presenting the financial position of a business concern as on a given date It presents a fair estimate of values of assets of a business as a going concern But *the Balance Sheet is not a valuation statement* because of the following reasons

(*i*) It does not show that the capital would be worth if assets were realised and liabilities paid off Instead, it shows how the capital stands invested Those who hold the view that the Balance Sheet is unreliable if the assets of a business concern would not realise the values stated in the Balance Sheet in the event of its liquidation, are under a misconception The assets are not shown in the Balance Sheet at their realisable values Unless there is reason to the contrary, they should be valued upon the basis of their worth to a going concern It is generally assumed that the business will continue and there will be no necessity for sacrificing the assets This principle is fundamental to the existence of confidence, which is an essential element for the success of all the business concerns

(*ii*) The determination of the realisable values of the assets is neither practically possible nor desirable Realisable or market value of an asset, say machinery, cannot be ascertained unless we place the machinery for sale and invite customers who would quote the price at which they would be ready to purchase it.

1 *Re The Kingston Cotton Mills Co. Ltd.* (1896)

GENERAL PRINCIPLES OF VALUATION

The basis or mode of valuation of different types of assets differs depending upon the nature of the concern and the purpose for which the assets are held The various assets of a concern may be broadly divided into fixed assets and floating assets. Now we proceed to deal with the methods of valuation of the two types of assets as usally appear in the Balance Sheet.

(a) **Fixed** assets of a business concern are those assets which are acquired not for resale, but for the purpose of enabling the business to be carried on They are held permanently for earning income, e g , land, building, plant and machinery, furniture etc Fixed assets which are gradually depleted or exhausted in the process of earning income are known as wasting assets, e g , mines, quarries, oil wells etc.

Fixed assets are valued for the purpose of the Balance Sheet as cost less adequate or reasonable depreciation The provision of depreciation on the fixed assets is necessary from legal as well as economic standpoint The market or the realisable value of the fixed assets is not taken into account at all Even the permanent fluctuation in the market price is ignored since it does not affect the earning capacity of a fixed asset and, therefore, is irrelevant for determining the trading profits of the business

Fixed assets in the form of wasting assets are not subject to depreciation through wear and tear For their valuation, it should be noted that it is "necessary to reduce the book value of the wasting assets to the extent of the estimated amount by which it has diminished in value" It has, however, become customary not to provide for depletion in stocks of the mineral resources.

Reference, however, may be made to the recommendation of the Institute of the Chartered Accountants in England and Wales, that in the case of assets of wasting character a provision for depreciation and depletion should be made according to the estimated exhaustion of these assets Such estimation may be made by correlating the quantity of output of a given period with the total estimated quantity in the mine The percentage of the total cost of the assets which has exhausted then should be found out and written off

(b) **Floating assets** are those in which the business is carried on and they are acquired for resale. They are continually changing day by day and are in the process of being converted into cash. Stock in trade, bills receivables, sundry debtors, cash etc are examples of floating or current assets

The general rule as regards the valuation of the floating assets for the Balance Sheet purposes is to value them at cost or market

price, whichever is lower, at the date of the Balance Sheet A temporary fall in the market price, however, may be ignored but any anticipated loss should be taken into account However, it should not be a prudent policy to anticipate a profit and take it into account before it is actually realised

BASIS FOR ASCERTAINING COST OR MARKET VALUE

Usually different bases are adopted for ascertaining the cost or calculating the market value The implication of the terms cost of market value may differ from concern to concern depending upon the nature of the concern and use of assets In case of a manufacturing concern, the cost means cost of production , in case of a trading concern, it would mean the cost of goods purchased plus direct expenses incurred on them

(i) **Cost of assets** Different methods for ascertaining the costs are as follows

(*a*) *Unit Cost Method* Under this method, each item is valued at its individual cost This method is very simple, but in practice it cannot be applied to a larger concern where large quantities of various items are maintained

(*b*) *First in First out Method* The cost is ascertained on the assumption that the goods which have been sold out or consumed were of the earliest purchases and the remaining goods are from the latest purchases In times of rising prices, it would inflate the profit

(*c*) *Last in First out Method* Under this method, the assumption is that the goods recently purchased have been sold out or consumed, and the stock on hand consists of earliest purchases and is priced accordingly In times of rising prices, the profit thus ascertained will be lower to that extent

(*d*) *Average Cost Method* The cost of all the goods purchased during the given period should be averaged and on the basis of such average derived, the cost of assests should be ascertained

(*e*) *Standard Cost Method* Certain concerns ascertain a standard cost on the basis of past experience, and subsequently all the cost are calculated on the basis of this predetermined standard cost.

(*f*) *Adjusted Selling Price Method* This method involves the estimation of value at current selling price which has to be adjusted For this estimated selling price, an amount equal to the estimated profit plus the estimated cost of disposal is deducted to arrive at the adjusted selling price

(*g*) *Base Stock Method* It is also known as Normal Stock or Minimum Stock system Under this method, it is assumed that certain minimum quantities of materials are always required They should be always valued at a fixed price from year to year and rest of the merchandise to be valued at cost or market price, whichever is lower

(ii) Market Value of Assets For the calculation of the market value there are following two recognised methods in use.

(*a*) *Net Realisable Value Method* It implies the value at which the goods can be sold out less the expenses to be incurred for selling them

(*b*) *Replacement Cost Method* This method entails the calculation of the price at which the same quantity of goods can be replaced at the market rate on the date of the Balance Sheet

VALUATION OF VARIOUS ASSETS

Land and Building Land is not subject to wear and tear by use and should be shown in the Balance Sheet at cost without charging any depreciation Unlike other fixed assets, the land should be valued at cost The fluctuations which take place in its value should be ignored as it does not affect its earning capacity

The buildings should be valued at cost, including the capital expenditure incurred thereon, less the depreciation at a reasonable rate Care should be taken that cost of fitting and fixtures etc in the building has not been included in the cost of building Cost of land and building should also be separated for the purpose of charging depreciation The assistance of a valuer may be taken for this purpose

The amount spent by way of repairs on the property should be charged as a revenue expenditure but if some extension has been done, that should be capitalised The auditor should examine the adequacy of the provision for depreciation made for such property.

We have discussed above land and buildings as fixed assets, but landholdings in the case of real estate-dealer will be a floating asset and not a fixed asset Accordingly the basis of valuation would change Land, in this case, should be valued at cost or market price, whichever is lower

Plant and Machinery. The valuation of machinery should be based upon its earning capacity It should not be based upon its realisable or replacement values

The auditor should carefully examine that proper and adequate provision for depreciation and obsolescence has been made He must see that even machinery not in use is properly and adequately provi-

ded for by adequate reserves The determination of the rate at which the depreciation should be charged is the duty of the management and not of the auditor But the auditor has to examine its adequacy He should see that depreciation should be so charged as to reduce the value of the machine to its residual value at the end of its estimated life To judge its adequacy, the auditor should be familiar with the machinery He must see that any fluctuation in the market price of the machinery is not brought into record

If the machinery has been purchased on hire-purchase or instalment system, he should see that it is depreciated on original cost value and not upon the amount of instalments paid

In case the plant or machinery is located and maintained abroad, the auditor should verify it with the help of certificate obtained from a local engineer

The auditor should also keep in mind the provisions of Companies Act, 1956, with regard to the rules of depreciation

Furnitures They are subject to heavier wear and tear and should be adequately provided for In case of the furniture belonging to a hotel or a cinema etc, he should see that a higher rate of depreciation has been charged than in the case of office furnitures Some furnitures and fixtures have no scrap value, e g, partition, shelves and fans etc and the auditor must see that they are properly charged to expenses Anyway, the adequacy of depreciation on the furnitures must be properly looked into by the auditor

Small Tools Usually, the revaluation of such tools is made at the end of each year and any difference between the revalued amount and original cost is charged to revenue Thus the method of revaluation is adopted for charging the depreciation of such tools It is advisable not to include any worn out or defective articles for the purpose of revaluation

Patents The auditor should ask for a schedule of all the patents in case he finds that a large number of patents are held He should see that the patents are written off over a period of their legal life, i e, 16 years It should be noted that the depreciation on patents arises mainly because of effluxion of time and hence the above basis of valuation should be adopted "Other causes of depreciation affecting patents are obsolescence, the impracticability of working the patent at a profit, or failure to induce the public to buy the patented article"

In case the patent continues to be of value after the expiry of its legal or official life, it should be revalued But on revaluation the auditor should see that its value should not be written up

Copyrights. The life of a copyright is considerably longer than the patents In general, it lasts for the life time of the author

and a period of fifty years after his death The practical method of its valuation is that each copyright should be revalued each year "The object should be to write the cost, in each case, off to revenue over the period of years during which this asset is estimated to produce income" Its cost cannot be written off over the whole period of life of copyrights, since in most of the cases they do not retain any value till the end of their legal life

Lorries, Motor-Cars, Carts and Vans The auditor should see that these assets should be dealt with in the same way as plant and machinery He should see that they are valued at cost and the rate of depreciation for lorries and motor-cars is higher, as depreciation of their engines is fairly rapid In case of carts and vans, he should allow depreciation at a lower rate, specially if they have been well-maintained by repairs and renewals of the parts However, he should see that expenditures on repairs have been charged to revenue account and not added to their cost.

Livestock The auditor should first obtain a schedule of such livestock He should also obtain, if he deems necessary, a certificate with regard to their valuation from a responsible official of the concern The suitable method for their valuation is to revalue them at the end of every year and the auditor should see that the difference between their cost and value thus ascertained should be written off In case the value is higher than the original cost, it should be valued at cost only. He should see that those livestock which expired during the year have been written off

Stock-in-trade Examination of the values assigned to stock in a concern is of considerable importance and this should be cautiously done by the auditor He should enquire into the bases of its valuation and see that a particular mode of valuation has been uniformly followed from year to year to arrive at correct amount of net profit or loss every year. Any change in the basis of valuation adopted should be duly enquired into and should be indicated in the Balance Sheet He should apply all the reasonable tests to check the stock sheets What is reasonable would depend upon the nature of business and records maintained in the concern

The recognised and accepted slogan with regard to the valuation of the stock is "cost or market price, whichever is lower"[1] The term 'cost or market' values have been used differently in different concerns, which have been already discussed earlier With whatever implication we use the terms there are two methods of its valuation, namely, Pick and Choose Method, and the Global Method

(i) **The Pick and Choose Method** It is also known as the Individual Method This method implies that we deal with each item of

1. F R.M de Paula, *The principles of Auditing* p 106.

stock separately and find out the cost or market price, whichever is lower, of each item Some writers feel that it results into ultra-conservatism

(ii) **Global Method** Under this method, each item of the stock is not taken into account separately The aggregate cost price of all the articles and their aggregate market price is calculated Then the entire inventory is valued at whichever of the two prices is lower. Let us take an example to illustrate this

(1) Items	(2) Cost Price	(3) Market Price	(4) Lower of the Cost or Market Price
	Rs	Rs.	Rs.
A	500	600	500
B	800	700	700
C	200	250	200
	1,500	1,550	1,400

Under the Pick and Choose Method the value of the Inventory would be Rs 1,400 which is the total of column (4) But according to the Global Method, the value of the inventory would be Rs 1,500 which is the total of column (2)

It should be noted that the Income Tax Law of India recognises both the methods of valuation mentioned above

The generally accepted principles of valuation of stock have, however, to be modified in case of the following kinds of goods in stock according to their nature

Raw Materials The raw materials constitute the original materials purchased with a view to manufacture the goods They should be valued at cost ignoring the market price The cost would, for this purpose, mean the invoice price plus freights, duty etc, incurred in bringing the material to the factory In case there is expectation of heavy fall in the market price of the raw materials, their net realisable value in the form of finished product should be taken into account for their valuation

Process or Semi finished Goods Those goods which are in the process of being converted into finished goods or so called partly-manufactured goods are valued at *cost* Market value should not be taken into account in this case also The cost would imply here the Works Cost, *i e*, cost of raw material plus the direct expenditures plus a normal works direct overhead but excluding all the fixed charges To verify the cost, the auditor should be familiar with the

cost system in operation in the concern In case there is no cost system in use, it will be difficult to obtain approximately correct costs The auditor must verify the standard cost of process goods and be certain that the items constituting factory overheads do not include selling, administrative and financial costs, but include all factory costs in addition to direct material and direct labour The repair jobs and manufacture of fixed assets should also not be included It will be advisable not to take any profit into account in this case.

Finished Goods If finished goods are purchased, they are valued at cost as in the case of raw material But if they are manufactured by concern, they should be valued at cost or market, whichever is lower Of course, anticipated profits need not be taken into account They may be valued at contract rates in case the goods have been sold under forward contracts but not delivered till the date of the Balance Sheet.

Plantation Products The plantation products, such as tea, coffee and rubber etc, are not valued according to the generally accepted principle of 'lower of the cost or market price' These products are valued at the net amount subsequently realised. It is feasible since the Final Accounts in such concerns are prepared when the crop has already been disposed off.

Wine, Timber, Rice, etc These products are of a special nature as their values increase with the passage of time The older the wine, the costlier it is This is why these goods are valued at above cost taking into account expenses incurred on their maintenance and a reasonable charge by way of interest on the amount of capital sunk In no case the goods should be valued at more than the market price prevailing on the date of the Balance Sheet for similar class of goods.

Goods on Consignment Unsold goods on consignment must be included in the stock and be valued at cost The basis of valuation of such goods must be carefully checked by the auditor He must see that they have been valued at cost, *i e*, invoice price of the goods plus freight and all charges incurred by the consignor Provision should be made for any unexpected fall in their price

Auditor's Duties Realising the importance of stock-in-trade in accounts, the auditor must examine the whole question of valuation of stock very carefully on the lines discussed above Regardless of legal responsibilities, he is ethically responsible for extreme caution so far as inventories are concerned He should satisfy himself with regard to the clerical accuracy of the inventories, their quantity on hand at the closing date and their correct pricing He should take all possible measures to satisfy himself that he has exercised reasonable care and skill in performing his duties and the value of the stock shown in the Balance Sheet is reasonably fair Also, that it does

not amount to distortion of the true and fair financial state of affairs of the concern.

As noted earlier, the value of various assets is determined by the management, but auditor must ascertain the basis of valuation and see that values are not assigned just arbitrarily He should test check the valuation of stock and see that the basis of valuation is quite consistent from year to year If there is a change in the basis of valuation, he must disclose the same in his report If he feels necessary and practicable, he should check the cost records in connection with the value of stock Any dissatisfaction with regard to the quantity, values, mode or basis of valuation etc must be duly disclosed by him in his report

Incomplete Contracts Contracts, specially for building construction may extend over two or three years and in such cases valuation for the Balance Sheet purposes involves considerable difficulties The controversial problem is whether the profits on such contracts in the course of completion should be taken into account while preparing the Final Accounts or not One view is that it is imprudent to take credit of such profits But it presents a practical difficulty It would mean that the concern will have to go without profits for several years It may also not be acceptable to the tax authorities.

But no hard and fast rule can be laid down about the determination of the anticipated profit to be credited in the current year. One thing which must be kept in mind is that the whole of the profits need not be taken into account and a portion of such profits should be reserved for contingencies The general practice in this connection is to value it at two-third or three-fourths of the total profit As a general maxim, it should be suggested that profit may be taken into account when at least one-third of the total work has been completed Proper costing system should be enforced in case the total income cannot be anticipated with reasonable certainty

One procedure in this connection is to "distribute the anticipated profit in terms of percentage of construction completed in each year on the period of its accrual and to adjust the final accounts of the last year" This method can however, be well applied where total income can be reasonably anticipated.

In case of forward contracts, ready for delivery they should be valued at contract price less and expenses to be incurred thereon for their delivery

For contracts which are undertaken on the basis of cost plus percentage-on-cost, say 15%, it would not be wrong to take profit into account when the cost has been already incurred

Investments The valuation of investments for purposes of the Balance Sheet will depend upon the object for which they are held

If the main object of holding the investments is to maintain them and distribute the income arising therefrom to the shareholders, the investments represent the fixed assets Investment as fixed asset is held by the Trust Companies They should be valued at cost, ignoring the market price Unless the articles of the company so require, even the permanent fall in their value need not be taken into account Unlike other fixed assets, the depreciation on them is not charged

The investments may be held as floating assets also if the chief object is to buy and sell them Investments of this nature are held by the finance companies Investments as floating assets should be valued at cost or market price, whichever is lower at the date of the Balance Sheet. Any fall in the market value of such investments must be provided for as a matter of sound financial policy.

Goodwill The auditor should see that proper method of valuation of goodwill has been adopted It should be noted that there are three principal methods of valuation of goodwill, as given below :

(*i*) *Purchase of Past Profit Method* Under this method, the profits for certain years, say five years, preceding the valuation of goodwill are averaged, then this annnal average is multiplied by the number of years during which the benefits of past working may be expected to continue Dicksee has given some multiples related to different concerns. He "lists one to five years' purchase as appropriate to trading business, one to four years to manufacturing concerns, one to three years to professional concerns, and about ten years to newspapers and quasi-monopolies [1]"

(*ii*) *Capitalisation of Future Maintainable Profits* Under this method, it is the relative earning capacity of the concern which is taken into account On the basis of past performance, estimation of average net profit expected to be earned in future is made Then this net profit is capitalised at the rate of return on capital investment in similar undertakings From this capitalised net profit, the value of the net tangible assets is deducted to arrive at the amount of goodwill.

(*iii*) *Purchase of Future Super Profits.* Super profit here implies "that part of profits which remains after providing an economic rate of remuneration for all labour and capital employed in a business" Under this method, first the super profits are calculated, then the estimation of probable duration of such super profits is made. This period is taken to be the number of years' purchase which has to be multiplied with super profits to arrive at the value of goodwill.

The valuation of goodwill for Prospectus purposes should also be very carefully enquired into by the auditor as the prospective investors may be interested in its proper value It will, however,

1 L R. Dicksee, *Goodwill and Its Treatment in Accounts*

depend entirely upon the opinion and policy of the promoters. In this connection he should see the following points.[1]

"(a) The earning capacity, in relation to the business, of the net assets being taken over ;

(b) the factors upon which (a) mainly depends, e.g, site value of premises, or reputation of commodities dealt in,

(c) the market rate of money ,

(d) whether the vendors are being paid in cash or are receiving deferred or other shares ,

(e) the age and nature of the business ,

(f) the number and relative size of the transactions ,

(g) the effect of the personality of the vendor, and whether his connection with the business is to be continued , if so, how much he will receive in salary as Managing Director ,

(h) monopoly value, licences, patents, etc. ,

(i) liability to restrictive legislation, discriminating excess taxation or other restrictions "

Auditors' Duties Goodwill does not wear and tear like other assets and is thus not shown at depreciated value The auditor should see that it appears in the Balance Sheet at cost As a matter of fact, it is difficult to estimate it He cannot insist to write it off out of profits unless the Articles, in case of company, so provide If asked to give advice, he should welcome it The prudent policy is to write it off, whenever possible, out of subsequent profits in times of prosperity There is no legal obligation,[2] however, to write it off before distributing dividends but it should be written off to strengthen the financial position of the company Since it is an asset of intangible nature, it should not be allowed to appear in the Balance Sheet for long However, in the Balance Sheet it should be shown at cost less any amount written off indicating the basis of valuation

The auditor should not have any concern with the fluctuations in the value of the goodwill because of increase or decrease in the profits of the concern As the value of this asset is based on the earning capacity of the concern, it does not remain constant Its value changes with the changes in the earning capacity of the concern. If the auditor finds other things satisfactory, he need not pay any attention to this aspect

1. Taylor and Perry, *Principles of Auditing*, pp. 297-98.
2. *Wilmer v McNamara & Co Ltd* (1895)

In connection with the valuation of goodwill it has been rightly observed that "Goodwill is a very intangible asset, and it is, therefore, a very sound policy to write the cost down out of available profits or reserves, and in this way ensure that the whole of the capital of the business is represented by tangible assets"[1]

Valuation of Shares For an accountant and the auditor, the valuation of shares is a perplexing problem indeed It is not the principles of valuation but their application which is baffling It is to be noted that normally an auditor has nothing to do with the valuation of shares of a company, unless he is specifically called upon to do it

The necessity for the valuation of shares of a company arises in the following circumstances

(i) For purposes of security when a bank has to lend money on the security of the shares

(ii) For the discharge of debts and liabilities in exceptional cases

(iii) For purposes of capital gearing when it is necessary to avoid heavy proportion of any type of share

(iv) For purpose of amalgamation and absorption etc.

(v) For purchasing shares for controlling their price

(vi) For estate duty purposes

(vii) In case of a mining concern, for estimating the break-up value[2]

In case the shares are quoted in the recognised stock exchange, the value of the shares may be readily ascertained with the help of the Official List published for the purpose If they are not officially quoted the newspapers should be consulted as they usually publish it But the real difficulty arises in case the shares are neither dealt in any of the stock exchange nor quoted in the Official List or the newspapers For this, there are two important bases, namely, "income basis" and "equity or net assets basis" We discuss them briefly below

Income Basis Under this method "The value of a share is arrived at by taking the rate of annual return divided by the return expected and multiplied by the par or paid-up amount of the share upon which the dividends is based, without taking into account any accruing dividend" It may appear to be a difficult calculation on the face of it but it is not so Suppose there are two companies *X* and *Y* *X* company pays a dividend of 15 per cent and *Y* company 10

1 F R.M. de Paula, *The Principles of Auditing*, p. 103.

2. W. Pickles, *Accountancy*, p 1178.

per cent on their ordinary shares of Rs 10 each In case of *X* company the shares are fully paid but in case of *Y* company they are only Rs 6 paid If the investors expect an annual return of 6 per cent, the value of shares would be

$$X \text{ Company } \frac{15}{6} \times 10 = \text{Rs. } 25$$

$$Y \text{ Company } \frac{10}{6} \times 6 = \text{Rs } 10$$

In case of *Y* company, the paid-up value of the shares has been taken into account for valuation purposes

Equity or Net Assets Basis Under this method the value of 'net assets" has to be estimated and with its help the value of each share is calculated "The procedure of arriving at the value of a share employed in the equity method is simply to estimate what the assets, less liabilities, are worth, i e the 'net' assets--allowing for a probable loss or possible profit on book values—the balance being available for shareholders Included in the liabilities may be debentures, debenture interest expenses outstanding, and possibly preference dividends if the articles of association stipulate for payment of 'arrears, in winding up "[1]

If, for instance, the book value of all the assets less fictitious assets is Rs 50 000 and the liabilities amount to Rs 30,000, the net assets would be Rs 20,000 If we deduct from it the amount of preference shares worth Rs 10,000, the total value of equity shares would be Rs 10,000, the total value of each equity share will be $\frac{10,000}{1,000}$ or Rs 10 only, total number of shares being 1,000

Auditor's duties The auditor should see that the proper method for the valuation of shares has been adopted and it has been correctly calculated having regard to all the relevant aspects He should consult the Memorandum and Articles of Association of the company He should also take into account the expected loss in future, if any But the object with which such valuation is to be carried on must not be lost sight of If necessary, he should compare the value with that of other companies in the similar trade

1. *Ibid* p, 1178.

QUESTIONS

1 What do you understand by valuation ? How does it differ from verification ?

2 What is valuation ? What steps should be taken by an auditor while undertaking valuation of various assets of a concern ?

3 Explain the general principles regarding valuation of fixed and floating assets

4 "Auditor is not a valuer and the balance sheet is not a valuation statement ' Explain this statement clearly and discuss the duties of an auditor regarding valuation

5 Explain the methods of valuation of goodwill Discuss the duties of an auditor in this regard

6 How would you undertake the valuation of stock of a trading concern ? Explain the duties of auditor regarding it

7 Describe the methods of valuation of shares of a company. Explain the duties of an auditor in this connection

8 How would you undertake the valuation of (a) plant and machinery, and (b) land and building

9 How would you, as an auditor, undertake the valuation of investment, small tools, patents, and copyrights

10. How would you undertake the valuation of following assets

(*a*) furnitures and fixtures,

(*b*) process or semi-finished goods ,

(*c*) goods on consignment ,

(*d*) incomplete contracts, and

(*e*) livestock.

11. Write short notes on the following ,

(*a*) Global method of valuation of stock ,

(*b*) Capitalisation of future maintainable profits ,

(*c*) Income basis of valuation of shares ;

(*d*) LIFO & FIFO, and

(*e*) Net realisable value

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Depreciation

Depreciation is a gradual but continuous decline or diminution in the book value of the fixed assets due to wear and tear, effluxion of time, obsolescence, or any other cause Distinction may be made between physical and functional depreciation Wear and tear should be looked upon as *physical depreciation* and obsolescence and inadequacy should be considered as *functional depreciation*

Definition To understand the concept of depreciation clearly; we give below some of the definitions

According to *L C Cropper* "Depreciation is the diminution in the financial value of an asset owing to wear and tear, effluxion of time, obsolescence or similar caues, the suggestion being rather that of gradual deterioration than sudden loss or diminution in value "

Carter has stated that "Depreciation is the gradual decrease in the value of an asset from any cause."[1]

F R M de Paula says "In practice, the term 'depreciation' is commonly used in a very wide sense, covering diminution in the values of assets caused by outside fluctuations in realisable and replacement values, and also the amortisation of the cost of an asset over the period of its use "[2]

Spicer and Pegler define it "as the measure of the exhaustion of the effective life of an asset from any cause during a given period "[3]

The Institute of Chartered Accountants in England and Wales in its Recommendation No 9 defines depreciation as "that part of the fixed asset to its owner which is not recoverable when the asset is finally put out of use by him Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned "[4]

1 Carter, *Advanced Accounts*, p 645.
2. F R M de Paula, *The Principles of Auditing*, Eleventh edition, p 135.
3 Spicer and Pegler, *Practical Auditing*, Eleventh edition, pp 115-16
4 Quoted by Spicer and Pegler, *op. cit*, p. 119

It will be clear from the above definitions that none of them is comprehensive As a matter of fact, the authorities on the subject differ widely and a logical and workable concept, especially in the changed circumstances of today, is yet to emerge The gravity of the problem may be understood by what Charles Smith has written "I have long struggled with a definition of depreciation In fact I have been a member of the National Committee which have been studying the subject of depreciation for many years That committee of the National Association of Railroad and Utilities Commission, 1943 finally gave up the attempt and substituted instead a *description* of depreciation "[1]

Depreciation and Fluctuation Depreciation should not be confused with fluctuations Fluctuations refer to the decrease or increase in the market price of a commodity Depreciation is applicable to fixed assets whereas fluctuations are usually related to the floating assets Depreciation is permanent, gradual and continuous decrease in the value of the fixed assets whereas fluctuation is temporary in nature depending upon the market conditions Provision of depreciation as a charge against the Profit and Loss Account is essential to ascertain the true and fair estimate of profit or loss whereas fluctuations are ignored It is because "Fluctuations in the value of assets have no relationship to the fact that all fixed assets, except land, are constantly wearing out and approaching a zero value" Fixed assets depreciate by use or otherwise and at the same time fluctuations in their value do also take place But since fluctuations or increase or decrease in the market value of the fixed assets do not affect the earning capacity or working life of such assets, they are not taken into account.

Main Object of Charging Depreciation Depreciation should be charged against the Profit and Loss Account as a loss with a view to recoup the capital invested in the purchase of fixed assets, specially the wasting ones Such assets are utilised to earn income In this process they lose value gradually due to wear and tear or obsolescence They may remain useful for a certain period but their working life is bound to come to an end Then their earning capacity is lost and they become valueless for the business concern All the capital invested in the purchase of these assets, less any scrap value, is lost Such expired capital outlay is a revenue loss just like other revenue losses Hence, it has to be provided as a loss in the Profit and Loss Account. For example, a machinery has been purchased for manufacturing purposes. Its working life is estimated to be twenty years After twenty years it will be valueless and all the original capital sunk in its purchase is lost Every year it loses part of the capital invested in it This loss is part of the total cost of manufacturing the goods Thus the cost of machine which has been used in the course of manufacture is part of the total cost like the cost of materials used, wages and other direct expenses Of course, the total

1 Charles Smith, "What concept of depreciation for fixed assets is most useful today " *Journal of Accountancy*, August 1951, p 169

nvestment in machinery has to be spread to twenty years and part of the earning every year is to be held back to recoup the original capital invested in its purchase Thus, the capital invested is kept intact to a marked extent.

If we do not make provision for depreciation, the Profit and Loss Account will not show the correct profit for the period and this will result in the return of part of capital by way of dividend which is legally prohibited and commercially unsound The Balance Sheet will also not exhibit the true and fair state of affairs because the assets will appear at their original value whereas it has, in fact, depreciated. The would result in overstating the value of such assets

A better approach is to keep in mind the replacement of such assets also which will be needed after the expiry of their working life With this view not only should depreciation be charged but money equal to the sum depreciation charged out of the Profit and Loss Account should be invested outside If it is not done, the amount thus held back will be utilised in the business as working capital and will thus be locked therein It will create problems of availability of capital at the time of replacement of the assets

ARGUMENTS REGARDING DEPRECIATION

Sometimes the clients may place arguments for making no provision of depreciation They may object to it on the ground that

(*i*) the asset, say machinery, has been maintained through repairs and is as good as new , or

(*ii*) that market value of asset is more than the original cost on the Balance Sheet , or

(*iii*) that it will prevent the declaration of dividend if depreciation is charged, or

(*iv*) that in the past excessive depreciation has been charged •

But these *arguments against charging depreciation have no force*

(*i*) To say that no depreciation is needed since constant repair has been undertaken is wrong It is because repairs are necessary to keep the asset in good working condition, whereas depreciation is necessary to provide for loss in its value due to its being utilised in the business Both should, therefore, be charged to Profit and Loss Account to arrive at correct profit or loss for the given period

(*ii*) The *second argument* also does not hold good since market value of a fixed asset has nothing to do with depreciation, as explained earlier

(*iii*) So far as the *third argument* is concerned, it should be emphasised that the question of dividend arises when profit has

already beed arrived at and the correct profit cannot be ascertained unless provision for depreciation has been made

(iv) With regard to the *last argument*, it should be mentioned that the depreciation for current year must be charged to revenue and excessive depreciation charged in the past may be transferred to a Reserve Account

DETERMINATION OF DEPRECIATION

It is a very important but difficult problem to measure depreciation in terms of money and determine the rate at which it should be charged The accountants have to work it out with the limitation that it cannot be measured accurately with mathematical precision At best, it can be estimated But its estimates should be as fair and reasonable as possible

There are *various factors* which affect the determination of rate of depreciation The auditor should see that they have been taken into account The usual factors are as follows

1 Cost of the assets

2. Expected working life of the assets.

3. Estimated residual, break-up or scrap value of the assets, if any

4 Obsolescence or effluxion of time

1 Cost of the assets Cost of the asset is a very important factor It may be found with the help of the books of account or invoices It may be the cost at which the asset was purchased (i e historical cost) or may be the cost at which the asset can be replaced (i e replacement cost) There is a controversy as to which cost should be taken into account The controversy arose specially owing to considerable increase in the price level after the World War The economists, industrialists and accountants started thinking afresh and felt that the original capital invested in the asset would be insufficient for its replacement According to them, the object of depreciation should be to provide for the cost of replacement

The Historical Cost Basis It is the oldest method and has got its own merits of being practical, easy and convenient It fulfils the objective of depreciation by providing for the sum of money originally invested in the asset. Still we should not be ignorant of its limitations as mentioned below

(i) It does not take into account the impact of continuous and upward trends in the general price level, which is very important Various countries, specially the developing ones, are experiencing rise in prices of a very high magnitude It does not fulfil the objective of providing necessary sum for the replacement of the fixed assets.

Since replacement costs are rising, the assets cannot be replaced unless depreciation is provided on the basis of the replacement cost

(ii) Profit determined for the given period may be overstated if this basis is applied and current value of money which is rapidly changing is not taken into account Moreover, income and expenditure of a business should be taken on a uniform basis It means that if we take sales into account at the current price, the depreciation should also be taken on that basis, i e replacement cost basis

(iii) It does not maintain the original capital intact in terms of the productive capacity of the assets

(iv) It does not measure the increase or decrease in wealth in terms of purchasing power

(v) It necessitates the retaining of enough earning so as to maintain the original physical capital intact, but it is not done in practice because of various pressures on finances of the company

(vi) The results shown by such accounts are not necessarily suitable for purposes such as price fixing, wage negotiations and taxation etc

Inspite of the various limitations mentioned above, the historical cost basis of charging depreciation is being widely used in U S A , U K and India The reason has been well emphasised in the recommendations of the Institute of Chartered Accounts in England and Wales "the alternatives to historical cost which have so far been suggested appear to have serious defects and their logical application would rise social and economic issues going far beyond the realms of accountancy" The Institute and other professional accounting bodies in England considered the problems but came out with recommendations to the members for appending supplementaries and footnotes for reflecting price level effects and sticking to the cost basis of valuation

In U S A also, repeated representations were made from time to time to change the basis of valuation to replacement cost But the Committee on Accounting Procedure of the American Institute of Accountants has several times reaffirmed its preference for the historical cost basis[1] The American Accounting Association in its *Revision of Accounting Concepts and Standards underlying Corporate Financial Statement* adhered to the cost basis and said, "There seems to have been no sound reason for repeated adjustment of capital values for the ordinary changes in price level commonly experienced from generation to generation"

1 In 1958 the American Institute of Certified Public Accountants completed an opinion survey among corporate executives and educators on price-level adjustment of depreciation The majority opinion shown was that present methods of reporting depreciation in financial statements should not be disturbed but that current dollar cost of depreciation should be disclosed in footnote to Balance Sheet

Replacement Cost Basis It has been adopted by some countries like Austria, West Germany, Belgium, Sweden, Switzerland, France, Japan and Latin American countries with a view to maintain capital in tact during this period of continued rising prices But adoption of the replacement cost instead of historical cost is not easy and is full of practical difficulties

(*i*) It is difficult to determine the replacement cost, specially in case of fixed assets, and in spite of considerable thinking on the subject, the authorities in U S A. and U K have not been able to come out with some suitable and practical basis

(*ii*) There are violent fluctuations in the market value, and the trend of price level after the end of the working life of the asset, say after twenty-five or thirty years, cannot be correctly estimated

(*iii*) There are many capital goods whose replacement value cannot be determined as that kind of capital goods may become outdated and new ones may come into use

(*iv*) The managing agents, directors or other officers of the company and the income-tax authorities would not like or allow the charge of depreciation at the increased rate since it would go to reduce the net profits

(*v*) It would result into interpretation of depreciation in a wider sense so as to include the loss of value of assets due to changes in the economic conditions If done so, it will include other changes too, say, changes in the consumers' habits or the technique of production etc All these will involve many serious and practical problems which cannot easily be solved through account.

(*vi*) The purpose of the depreciation charge is not to provide for a fund which may be available for the replacement of the asset but for accounting the cost of its using up by way of an expenditure, as explained earlier

As a compromise, in the U S A and India etc provision has been made for plant rehabilitation The importance of such provision has to be realised well by the accountants because of growing inflationary trend Spicer and Pegler have also emphasised this while they say that there can be no doubt, however, that where it is anticipated that the cost of replacing a fixed asset will be greatly in excess of its original cost commercial prudence demands that profits be set aside, so far as is practicable, to provide the additional funds which eventually will be required for replacement [1]

2 **Expected working life of the assets** For the purpose of depreciation, the working life of the assets has to be ascertained But the difficulty is that the working life may be only estimated on the

[1] *Op. Cit*, p. 121

basis of past experience, and expert and technical knowledge There is no definite standard of measurement of the useful life of various types of assets Their life is affected by (i) maintenance by way of repairs and renewals of the assets, (ii) the use to which they are put and the conditions with regard to the exposure, e g , use of a plant or machinery beyond its working life, particularly during the war periods, even if it is worn out, and (iii) obsolescence when a new discovery is made and the old machinery loses its advantages

Bell and Johns,[1] while raising the difficulty in measurement of expected life, give 'general indications of commonly accepted estimates of the useful life of the respective classes of depreciable property, under usual conditions" as follows

Assets	Years
Buildings	
Concrete	50-60
Brick	40 50
Frame	25-30
Building equipments—elevators etc	15-20
Machinery and factory equipments	8-15
Furnitures and Fixtures, including office appliances	5-15
Automobiles	3-5

Estimation of working life of plant and machinery poses difficult problems The best way to deal with them is to maintain a special Plant Register In this register, details of each machines should be clearly recorded It should have columns for opening balances of the plant and machinery, additions made during the year, their nature, their estimated life, scrap value, repairs affected during the year, and their original cost etc There should also be columns for recording the rate of depreciation and the amount of depreciation written off Sale of any plant and machinery during the year should also be recorded If possible, working hours of each plant and machinery should be mentioned in the Register At the end of the year, a statement in the form of summaries should be prepared with the help of the Register It should show in totals the opening balance, the additions, the total depreciation written off, sales and the profit or losses thereon, and the closing balance in respect of each machinery

3 **Residual Value of the Asset** It is also known as break-up value, scrap value, or salvage value It has also to be estimated beforehand to determine the rate of depreciation since exact values cannot be found out unless the assets become useless and are put to sale As the purpose of depreciation is to write off the capital lost owing to the use of the assets, the whole of the original capital sunk by way of investment in the assets is not taken into account From that a deduction for estimated residual value of the assets is made For example, if a machinery has been purchased for Rs 10,000

1 Bell & John *Auditing* Third Edition, p 256

and if sold after 15 years its scrap realises Rs. 1,500 only, then Rs 8,500 and not Rs 10,000 should be written off by way of depreciation

9 **Obsolescene or Effluxion of Time** It is an important external factor which has got its bearing on the determination of depreciation Obsolescence, in case of plant and machinery, implies that a new and improved machinery has been invented, making the old machinery out of-date The new machinery has better capacity to manufacture the goods at cheaper rate and in larger quantity This would necessitate the replacement and installation of new plant in place of the old one to complete in the business world It would mean that while fixing the rate of depreciation such eventuality has to be taken into account The period fixed by way of expected working life has to be reduced considering this fact But it is full of practical difficulties It cannot be forecast when an invention will take place To deal with this problem, F R M de Paula suggests "that the better course is to deal with this contingency separately, from the provision for normal depreciation, by means of appropriation of profits to a special obsolescence reserve The great value of such reserves is being appreciated by industries today "[1]

There is no such difficulty in dealing with the effluxion of time which is an external factor related with the assets under lease When the fixed period of the lease terminates, the asset loses all its value The total amount originally paid for the lease has to be written off to Profit and Loss Account over this period of the lease For instance, if a land has been taken on lease of 100 years for Rs 1,00,000, then Rs 1,000 should be charged to Profit and Loss Account every year. Thus, after the end of life of lease, i e 100 years, there will be no balance left in the Leased Land Account

METHODS OF DEPRECIATION

There are several methods of providing for depreciation in the value of fixed assets The principal methods are briefly described below

1 **Fixed Instalment or Straight Line Method** According to this method, a fixed proportion of the original cost of the asset is written off each year The amount fixed is such as to reduce the book value of the asset at the end of its life to zero or break-up value The formula applied for this is as follows

$$\text{Depreciation} = \frac{\text{Cost of the Asset} - \text{Breakup value}}{\text{Life of Asset}}$$

This method is simple and easy to work out and is applied generally to those assets which either do not have residual value or

1 *The Principles of Auditing*, p 139

are of less value and do not need heavy repair and renewals, *e g*, lease, patent or furniture, etc

2 **Reducing Instalment or Written-down Value or Diminishing Balance Method** Under this method, the depreciation is charged at a given fixed percentage on the diminishing value of the asset or in other words, on the debit balance of the asset account in the beginning of the year An effort is made to reduce the asset to breaking-up value at the end of the life of the asset Repairs and renewals have to be charged to the Profit and Loss Account separately This method is recognised by the income-tax authorities and has got the merit that no fresh calculation is needed for any addition in the asset as the percentage at which the depreciation should be charged is already fixed Also, it does not place undue burden on the revenue as depreciation and repairs remain more or less equal from year to year The system is more suitable for assets which have some residual value and additions take place frequently, *e g*, plant and machinery, motor vehicles, buildings, etc

3 **Annuity Method** Under this method interest on capital invested in the asset is also taken into account along with depreciation on that This method is based on the assumption that the capital invested in the asset earns a certain rate of interest Therefore, the asset account is credited with the depreciation and at the same time debited with the interest at a fixed percentage on the diminishing value of the asset The asset is to be reduced, thus, to nil at the end of its life This method is not commonly used and is suitably particularly to those assets which have got a long life but need huge investments, *e g*, long lease.

4 **Depreciation Fund Method** This method takes into account the replacement of the asset also According to this method, an equal amount is charged by way of depreciation to the Profit and Loss Account each year and credited to a Depreciation Fund Account An equivalent amount of cash is invested outside the business and allowed to accumulate at compound interest The amount to be charged for depreciation and investment may be ascertained by consulting ready-made Sinking Fund Depreciation Tables At the end of the life of the assets, the investments are disposed off and money thus realised is available for the purchase of the new asset This system is suitable for those assets which are costly but have to be replaced after certain period, *e g*, plant and machinery, wasting but costly assets

5 **Insurance Policy Method** Under this method, an endowment policy is taken out for the estimated life of the asset Like the Depreciation Fund Method, its object is to make available the amount required at the end of the particular period. It saves the botheration of selection of securities and investments of money along with the interests earned on previous investment every year and eliminates the risks involved. It only involves the payment of premium every year to the insurance company and collection of policy amount from the company at maturity

6 **Revaluation Method** According to this method, the asset is revalued every year and estimated fall in the value is charged by way of depreciation It is suitable to some special types of assets such as loose tools, horses, cattle, sacks, casks, bottles etc

7 **Depletion Unit Method** This method is specially applicable to mines, quarries and sand pits etc A sum by way of depreciation is provided each year which represents the expired capital outlay on the basis of the output compared with the estimated total workable deposits of the mine, etc In other words, cost of the asset is divided by the total workable deposits and it gives the rate of depreciation per unit of output This rate is applied to the total output of a given period to determine the amount of depreciation for the period.

8 **Machine Hour Method** Under this method, the total number of hours which a particular machinery will work during the whole of its effective life is estimated The estimated number of hours is, then, divided by the cost of the machine less any residual value to ascertain the hourly rate of depreciation To calculate the depreciation for a particular year, this hourly rate of depreciation is to be applied to the number of hours which the machine has worked during that year

DEPRECIATION AND THE COMPANIES ACT, 1956

In case of a joint stock company, the auditor should proceed cautiously while examining the provision for depreciation He was to be familiar with the contents of the Articles of Association of the company and the specific provisions of the Companies Act, 1956 affecting depreciation It is necessary because depreciation in case of a company has to be provided according to law.

The Act contains specific provisions to the effect that the depreciation of fixed assets of the company must compulsorily be provided for before arriving at the amount of profit available for dividends Section 205 of the Act specifically provides that no dividend can be declared or paid except "out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of section 205 (2)" It clearly implies that the depreciation must be provided for if dividend has to be declared or paid.

"Every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year" (section 211) It means that the depreciation must be charged otherwise the Profit and Loss Account would not disclose a true and fair profit and loss This section also requires that the Balance Sheet of a company shall give a true and fair view of state of affairs of the company That also necessitates the provision for depreciation

The Profit and Loss Account should give information as to "the amount provided for depreciation, renewals or diminution in value of fixed assets. If such provision is not made by means of a

depreciation charge, the method adopted for making such provision If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with section 205 (2) of the Act shall be disclosed by way of note" (Part II of Schedule VI)

Rules for calculation of Depreciation The following rules for the provision of depreciation have been provided under section 205(2) of the Act It may be noted that the Companies Act, 1956 gives recognition to only two methods of charging depreciation, *viz*, straight line method, and diminishing balance or reducing instalment method.

(1) Depreciation must be charged at the rates prescribed for different assets by the Income Tax Act, 1961 and the Rules framed thereunder (section 350) This is in respect of normal depreciation including the extra allowances admissible for extra and multiple shifts, but excluding therefrom any special, initial or other depreciation, or development rebate, whether allowed by the Act or the Rules or otherwise The depreciation should be calculated with reference to the written-down value of the assets as shown by the books of the company at the end of the financial year expiring at the commencement of the Act or immediately thereafter and at the end of each subsequent financial year This allows use of *diminishing balance method*

(2) It may be calculated at a rate determined by dividing 95% of the original cost of the asset to the company by the specified period in respect of such asset This is the same in *straight line method*

(3) Depreciation may be charged on any other basis provided it has been approved by the Central Government, and it has the effect of writing off by way of depreciation 95% of the original cost to the company of each depreciable asset at the expiry of the specified period

In case, the depreciation has been provided in the manner mentioned in the above paragraphs (2) or (3) on an asset being sold, discarded, demolished, or destroyed, the written down value thereof at the end of the financial year in which it is sold, discarded, demolished or destroyed, must be written off in that year

(4) In case the company holds such other depreciable assets for which no rate of depreciation has been provided by the Income Tax Act, 1961 or the Rules framed thereunder, the depreciation should be charged on such basis as may be approved by the Central Government by any general order published in the official gazette or by any special order in a particular case

According to a clarification by the Department of Company Law Administration, depreciation should also be provided for on an immovable property, held as an investment and not used for purposes

of the business of the company, to arrive at correct amount of divisible profit If such depreciation is not charged, the Profit and Loss Account would not be deemed to give a true and fair view of state of affairs of the company It is to be noted that such provision for depreciation should be made regardless of the fact that such depreciation is not admissible under the Income Tax Act, 1961

Moreover, the depreciation should be charged even through the asset remained idle during the whole or part of the year concerned A company may use different methods of depreciation for different types of assets Further, if an asset has already been depreciated to 5 per cent or below its original cost, it could not be statutorily necessary to charge further depreciation every year till the same asset is sold, discarded, destroyed or demolished.

Arrears of Depreciation There are provisions to section 205(1) with regard to provision of arrears of depreciation In case a company has not provided for depreciation for any financial year or years ending after 28th December, 1960, it shall make provision for depreciation before declaring or paying dividends .

(*a*) either out of profits of that financial year , or

(*b*) out of profits of any other previous financial year or years

But there are two exceptions to the above rules

(*i*) The profits of a financial year (or years) which falls before the commencement of the Companies (Amendment) Act, 1960, may be distributed even though no provision for deprecion was made before arriving at the profits

(*ii*) The Central Government has been empowered to permit a company not to make provision for depreciation before declaring or paying dividends if it thinks necessary to do so in the public interest

Change in Mode of Charging Depreciation. The management is free to change the method of charging depreciation, as there is no legal restriction in this connection They may even adopt different methods for different types of assets The auditor is simply required to see that adequate provision of depreciation has been made and that it does not affect the true and fair position of the concern It has been suggested in this connection that "if the method of charging depreciation is changed, the provision should be re-calculated from the original date when the asset came in use Also a surplus arising out of the change in the method of charging depreciation should be transferred to general reserves through the profit and loss appropriation account Similarly if there is a deficiency, it should be made up by debiting the general reserve through the profit and loss appropriation account Full depreciation for the year in which the method of depreciation is changed, should be calculated in accordance with the new method and debited to profit and loss account of the year "

AUDITOR'S DUTIES

An auditor finds himself in difficult position while verifying the provision for depreciation He is not expected to have technical knowledge and is faced with the problem of estimating the amount of depreciation as may be necessary and adequate in case of various fixed assets In fact, the amount of depreciation to be provided for has to be decided by the directors or other authorised officials of the concern The auditor's main duty is to see that adequate provision for depreciation has been made on sound and correct principles so that the Profits and Loss Account and the Balance Sheet exhibit a true and fair view of the state of affairs of the concern He should see that the whole question has been properly dealt with by some responsible official He has to judge the adequacy of the rate of depreciation by ascertaining that it will keep capital sunk in the fixed assets in tact and will be able to reduce the book value of the asset to its residual value at the end of its life For this he should seek help from technical experts He has to see that the method and rate of depreciation once adopted are being consistently followed from year to year In case a change is affected he must duly enquire into it and report the matter

If after reviewing the whole situation he feels that insufficient provision of depreciation has been made resulting into undue inflation of the profit, he should place the matter before the management for consideration and necessary correction If they do not accept his advice, he must unhesitatingly refer this point in his audit report

In case of a company, he should also see that the provisions of the Act have been duly compiled with He should see that the amount provided for depreciation, renewals or deminution in value of fixed assets has been separately stated. Loss on account of obsolescence should also be separately shown In case no provision has been made for depreciation, this fact should also be stated A note should be given with regard to the quantum of arrears of depreciation He should also give a note regarding any change in the method of depreciation

In short, the auditor should be well-versed in the principles, customs and legal provisions relating to depreciation.

QUESTIONS

1 What do you understand by depreciation? Explain the necessity for charging depreciation

2 What is depreciation? Explain the duties of an auditor regarding it

3 Discuss the various factors which affect the determination of depreciation

4 Briefly explain the various methods of charging depreciation and duties of auditor in this regard

5 Explain the importance of historical and replacement cost regarding depreciation

6 Define auditing Explain the provisions of Companies Act, 1956, in this regard

7 What should you, as an auditor, do regarding the arrears of depreciation and change in the method of charging depreciation

8 Explain the rules for charging depreciation, as provided under the Companies Act, 1956

9 Your client has put the following arguments for not charging depreciation

(a) Due to proper maintenance, the asset is as good as new ,

(b) The market value of the asset is more than the book value ,

(c) Current year's profit is not sufficient for charging depreciation , and

(d) In the past excessive depreciation has already been charged, As an auditor, how would you reply ?

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Reserves and Funds

A sound and prudent financial policy demands that the proprietor or the management of a concern should make provisions out of profits to meet the foreseen or unforeseen losses in future It is essential as a business concern is not always expected to have smooth sailing These provisions, if made in good years, may be utilised for meeting such losses in lean years They are made in different forms with different objectives They may be in the forms of reserves or funds An auditor usually comes across the existence of a reserve in most of the concerns He has to be familiar with different types of reserves and funds which may be created.

Classification of Reserves and Funds

- Published
  - Revenue
    - Reserves
      - General
      - Specific
    - Funds
      - Reserve Funds
      - Specific Funds
      - Sinking Funds
  - Capital
- Unpublished (Secret)

PUBLISHED RESERVES AND FUNDS

All the provisions made in a concern, with the exception of Secret Reserves, are duly disclosed in accounts. They are clearly shown in the Balance Sheet and anybody who consults it is able to know their existence easily In case of a Joint Stock Company, the Final Accounts are duly published and these reserves are also disclosed therein They may be further classified as Revenue Reserve and and Capital Reserve

REVENUE RESERVES

A revenue reserve is a charge against the Profit and Loss Account It represents all the amounts which are set aside out of revenue profits of a concern and which are available for distribution through the Profit and Loss Account On the other hand, capital reserve represents capital items and is created out of capital profits It is not available for distribution as dividend. The revenue reserves may be in the form of reserves or funds

RESERVES

A reserve is a charge against Profit and Loss Account with a view to meet general contingencies or specific probable losses It may be broadly classified into General Reserves and Specific Reserves

(i) **General Reserves** Reserve created with the objective of meeting general contingencies and strengthening financial soundness is known as General Reserve It may be for a contingent liability which may become an actual liability on the happening of certain events in the future This reserve is utilised to meet the loss to the concern when such contingent liability becomes actual However, it is to be noted that creation of such reserves is a matter of financial policy It strengthens the general financial situation of the concern, therefore, it should be created as far as possible.

(ii) **Specific Reserves.** A reserve is also created with a view to meet specific and probable losses The instances of such reserves are .

(*a*) *Reserve for Bad and Doubtful Debts* This reserve is necessary because some of the debts are bound to be bad and the sundry debtors will not appear in the Balance Sheet at their real value if such reserves are not created The amount of such doubtful or bad debts cannot be accurately ascertained but on the basis of past experience it should be estimated and reserve to that effect should be created with the estimated amount [1]

(*b*) *Reserve for Discount* It is created with the objective to provide for discounts allowed to debtors or recieved from the creditors Reserve for Discount on Debtors is maintained with a view to provide for the loss by way of discount allowed to debtors when payments are received from them Reserve for Discount on Creditors is created by crediting the Profit and Loss Account with a view to provide for the discounts to be received from the creditors on payment made to them.

(*c*) *Reserve for Repairs and Renewals* This reserve is created with a riew to provide for repairs and renewals of fixed assets It

1 Adequacy of Reserve for Bad and Doubtful Debts has been emphasised in *Re The London and General Bank*, (1895) and *A E Green & Co. v. The Central Advance and Discount Corporation Ltd* (1920)

is particularly related to the repairs and renewals of machinery The main objective of the reserve is to equalise the burdens of repairs and renewals on the Profit and Loss Account from year to year When the machinery is new, less expenses have to be incurred by way of repairs and renewals But this expenditure increases progressively as the machinery grows old It the amount of repairs and renewals incurred every year is charged to Profit and Loss Account for that year it would result into lighter burden on Profit and Loss Account in the earlier years and heavier burden when the machinery gets older As such the burden on the Profit and Loss Account will be quite disproportionate This reserve, therefore, removes the discrepancy by making an equal annual charge against the Profit and Loss Account as the amount of actual repairs are charged to the Reserves and not to Ptofit and Loss Account

DIFFERENCE BETWEEN PROVISIONS AND RESERVES

The Indian Companies Act 1956 has made a distinction between the provisions and reserves Therefore, the distinction between the two must be understood clearly A provision is made out of profits of the concern to meet (a) deprediation, renewals, or diminution the value of assets such as investment , and (b) any known liability the amount of which cannot be ascertained yet Thus, provision is made for known liabilities for which the amount of liability can not be ascertained on the date of the balance sheet Examples of provisions are Provision for the Bad and Doubtful Debts, Provision for Discounts, Provision for Repairs und Replacements, Provision for Fluctuations in the Investments, Provision for Taxation etc. Whereas the reserves are appropriations of the profit of the concern specially with a view to strengthen the financial condition of the concern A reserve is not created to meet any known liability It is created for any contingency which may arise in future

A few *points of distinction* between two are as follows

(i) A provision is a charge against profits whereas a reserve is an appropeiation of profits

(*ii*) A provision is created even if there is no profit, whereas a reserve is created only when there are profits

(*iii*) A provision is created for the known liability whereas a reserve is created for unknown contingencies with a view to strengthen the financial position of the concern

(*iv*) The amount of the provision cannot be ascertained on the date of the balance sheet and is to be determined on the basis of past experience, whereas the amount of reserve is a matter of policy or discreation on the part of management

(*v*) The amount to the balance of the provision is not available for dividend to the shareholders of the concern whereas the amount

of reserve is an appropriation of profits and, therefore, is available to them as dividends

FUNDS

They may be classified as Reserve Funds, Specific Funds and Sinking Funds

(i) **Reserve Funds** A Reserve Fund may be defined as a sum set aside out of the divisible profits with a view to strengthen the financial position of the concern. It implies that it is a charge against the Profit and Loss Appropriation Account and not against Profit and Loss Account Thus a part of the profit which has to be distributed to the shareholders by way of dividends is retained to meet the unknown future losses It represents, then, the surplus of assets over capital and liabilities, if correct valuation of assets and liabilities has been done Such funds may be made available for the distribution of dividends if the Articles so permit

There are two controversial points with regard to Reserve Funds.

(i) Should a Reserve Fund and debit balance or Profit and Loss Account appear together? There is difference of opinion in this respect Some argue that Reserve Fund should be at once utilised towards extinguishing the debit balance of Profit and Loss Account but it does not seem to be quite sound The Reserve Funds and debit balance of Profit and Loss Account may appear side by side in the Balance Sheet It is because if the Reserve Funds have been created with a view to strengthen the financial position of the concern it will serve its purpose well if left in the books rather than being utilised for extinction of loss It will be in the interest of creditors also as it provides them further safety Moreover, a Reserve Fund represents the profits retained in the past and debit balance of the Profit and Loss Account shows the revenue loss of a particular year The latter should be allowed to appear in the Balance Sheet to show clearly the loss of the current year In case it is extinguished by utilisation of reserve funds the Balance Sheet will not show true state of affairs of the concern It is however, suggested that "if losses are incurred year after year due to some temporary cause, and the appearance of losses in the Balance Sheet is likely to jeopardise the credit of the company, Reserve Fund may be credited, wholly or partially, to Profit and Loss Account"[1]

(ii) Should the Reserve Funds be necessarily invested outside or not? The purpose and form of the creation of Reserve Funds do not warrant their investment outside the business They may be correctly merged in the general assets of the company The purpose of Reserve Funds is to strengthen the financial position of the concern and it can very well be met by retaining the Funds in the con-

1. A N. Agarwala, *The Higher Science of Accountancy*, p 629

ᵓrn which will enhance the working capital. So far as its form is ɔncerned, it should be created by retaining a part of divisible profit

However, as a matter of business policy, if it is felt that they hould be invested outside the business, it should be so arranged that eady money is available when required If the amount of Reserve ᶠund is left in the business itself, it is locked and may create difficulty when ready money may be required.

Thus, the investment of Reserve Fund outside the business is ıot compulsory It may or may not be invested depending upon nerit of the circumstances prevailing in the business If funds for vorking capital are needed, it is advisable to leave the Reserve Funds n the concern instead of investing them and then borrowing from he banks or other sources On the other hand, if ready money is ıeeded only at some future date, they should be invested outside the business

Reserve and Reserve Fund There are two main differences between Reserve and Reserve Fund (*i*) A Reserve is created by making a charge against the Profit and Loss Account whereas the Reserve Fund is a charge against the Profit and Loss Appropriation Account (*ii*) The object of creation of Reserve is to provide for anticipated or contingent liabilities or loss, whereas the object of creation of Reserve Fund is to strengthen the financial position of the concern

Reserve Fund and Reserve Account A distinction is made between two types of Reserve Funds—those which are represented by specific investments outside the business, and those which are employed in the business itself and not invested in outside securities To differentiate the two, different terms are employed A reserve which is invested outside the business should be called Reserve Fund and a reserve which is not represented by specific investments outside the business should be called Reserve Account

(ii) **Specific Fund** It is created out of Profit and Loss Appropriation Account with some specific purpose and is usually invested outside It may be for equalisation of dividends

Dividend Equalisation Fund It is a kind of specific Reserve Fund created by setting aside a sum out of divisible profit with a view to equalise dividend in less prosperous years Whenever the concern is unable to declare the dividends at usual rates because of insufficient profits, this reserve may be utilised for the purpose This fund would maintain stability in the rate of dividend declared from year to year It should be noted that the fluctuations in the rate of dividend from year to year affect the credit of the concern since it is reflected in the market value of the shares Fluctuations in the market value of the shares indicate instability and unsoundness of the financial picture of the concern

(iii) **Sinking Fund** A Sinking Fund is created by setting aside periodically a definite sum of money, which is invested in outside securities with a view to provide accumulated funds in future to fulfil specific objectives Lancaster defines it as "any fund which is created

by the regular investment of such an amount as, with compound interest earned thereon, will accumulate to a given sum at the end of a stated period "

Thus it should be clear that the Sinking Fund is always created with certain specific objectives These objectives are : (*i*) repayment of liability, *e g*, redemption of debenture or repayment of loans, and (*ii*) replacement of a wasting asset Further, the sums set aside periodically, say annually, have necessarily to be invested in outside securities unlike the Reserve Funds It is essential to meet the above-mentioned specific objectives In future, whenever there is need of funds either for replacement of wasting assets or repayment of liabilities, the securities are sold out and the proceeds are utilised to meet the ends This Fund is not to be utilised for any purpose other than that for which it is created The above two specific features of Sinking Fund distinguish it from other types of reserves or funds

Creation of Sinking Fund The way a Sinking Fund is created depends upon the object with which it is created If the object is the repayment of liabilities, it is created by debiting Profit and Loss Appropriation Account as the loans represent an item of capital nature and, therefore, should not be charged to Profit and Loss Account But if the object is to provide for the replacement of a wasting asset, it is created by debiting the Profit and Loss Account The reason is that the asset has to be replaced because it depreciates by use in the business and this loss should be charged to Profit and Loss Account like any other revenue loss

The points of difference between the Sinking Fund for Repayment of Liabilities and Sinking Fund for Replacement of Assets are as follows (*i*) The former is provided from the Profit and Loss Appropriation Account and the latter is provided from the Profit and Loss Account (*ii*) In the former case, after the redemption of liabilities, the Sinking Fund Account is closed by a transfer to Reserve Fund Account As it was created by retaining a sum out of distributable profit, it may be made available to shareholders But in case of Sinking Fund for Replacement of Asset the Sinking Fund Account is closed by transfer to the old Asset Account.

Capitalisation of Revenue Reserves Sometimes it happens, specially in case of a joint stock company, that substantial revenue reserves accumulate These accumulated reserves are usually capitalised Their capitalisation may also become necessary to reduce the rate of dividend with a view to pacify the competitors, the Government, the labourers and even the consumers The accumulation of such reserves increases the working capital and consequently the earning capacity of the concern With the increase in the profit, the rate of dividend, capital remaining the same, rises at an artificially high rate A high rate of dividend is envied by everybody

A revenue reserve may be capitalised in two ways (*a*) by issue of bonus shares, and (*b*) by taking partly paid shares into fully paid shares

With the capitalisation of such reserves the rate of dividend automatically goes down substantially But it is only the *rate* of dividend that is reduced, although the profit or the total distribution o the shareholders remains the same For instance, suppose the share capital of a concern is Rs 50,000 and it has accumulated a eserve of Rs 30,000 If the profit earned by it is Rs 10,000, the rate of dividend on original capital would be 20 per cent But if the reserves are capitalised, the capital would become Rs 80,000 and then the rate of dividend would come down to 12 5 per cent only.

CAPITAL RESERVES

A Capital Reserve is one which is created out of capital profits In general, such capital reserve is not freely available for distribution as dividends to shareholders It may be utilised, however, to meet the capital losses or abnormal revenue losses, *e g*, preliminary expenses, underwriting commission etc

The capital profits, which are utilised for the creation of Capital Reserves, may arise in the following circumstances —

(*i*) Profits realised on sale or fixed assets
(*ii*) Premiums received on issue of shares or debentures.
(*iii*) Profits made on redemption of debentures at a discount
(*iv*) Profits obtained from the forfeiture and reissue of shares.
(*v*) Profits obtained prior to incorporation of a limited company
(*vi*) Exceptional profits earned not in regular course

The Capital Reserve should be shown separately from the Revenue Reserves in the Balance Sheet It is not essential to invest it in outside securities It may or may not be, as it is a matter of business policy

UNPUBLISHED OR SECRET RESERVES

Some companies, specially banks and financial institutions, create and maintain secret reserves which are not published The creation of such reserves strengthens the financial soundness of the concern Its financial picture would be better than what it would appear on the face of the Balance Sheet But since it is not disclosed in the Balance Sheet and is secretly maintained, it is usually difficult to trace its existence A careful and intelligent review of the accounts alone may give indication of its existence

Methods of Creation We give below some of the methods of creation of Secret Reserves

(*i*) By undervaluation of assets such as stock or book debts.
(*ii*) By overvaluation of liabilities
(*iii*) By charging depreciation at a higher rate.
(*iv*) By writing down the asset, like goodwill, to almost nil.
(*v*) By charging capital items to revenue.

(*vi*) By making excessive provision for contingent liabilities

(*vii*) By taking the contingent liability as actual one in the accounts

(*viii*) By creating excessive reserves for bad and doubtful debts or for discounts

Objections to Secret Reserve Its creation is objected because of the following reasons

(*i*) One serious objection is that the Balance Sheet does not exhibit true and fair view of the financial affairs of the concern if a Secret Reserve is created and maintained At the same time, the Profit and Loss Account also does not give the correct results since excessive provisions for depreciation or reserves etc may be made for its creation

(*ii*) It is not disclosed to shareholders who are the real owners of the company They do not get a correct picture of the state of affairs of their company, as also the real value of their holdings. They are deprived of dividends to the extent the Secret Reserves are not utilised well

(*iii*) The Secret Reserve may be utilised by the management to conceal their weakness in the form of mismanagement It may give them a chance to indulge in speculation which may turn out to be ruinous to the company

(*iv*) With the help of Secret Reserve, the management may carry on fraudulent activities secretly They may lower down the rate of dividend by creating the reserve It would lower down the value of shares and then the management may purchase the shares. Later on, by utilising the Secret Reserve they may declare dividend at a high rate, thus raising the value of shares and then selling them at a higher price to earn huge profits

(*v*) If Secret Reserves have been created by undervaluation of assets, then the company cannot claim from the insurance company the full value of those assets if they are destroyed by fire It would thus cause a loss to the company

(*vi*) Any leakage as to the utilisation of Secret Reserve, for the equalisation of dividend in the event of loss from year to year, may shake the confidence of the parties interested in the affairs of the company.

Merits Inspite of various dangers and objections to the creation and maintenance of Secret Reserve, it has got the following points in its favour

(*i*) Its maintenance brings soundness in the financial position of the concern and it may face any financial adversity in future without much difficulty.

(*ii*) It may be utilised for equalisation of dividends, thereby maintaining the financial stability of the company

(*iii*) It enhances the working capital of the company as a part of the profit is withheld from distribution as dividend

(*iv*) In the event of abnormal prosperity, it presents a less sound financial picture It conceals the attractive prospects of the business from others and to a certain extent prevents them from entering into competition

(*v*) It serves the purpose of creating reserves without the knowledge of the shareholders who would like this amount to be distributed as dividend.

Secret Reserves and Companies Act, 1956 The Secret Reserves are prohibited by the Companies Act except in case of financial companies like the banking and insurance companies, where it is necessary to create such reserves The Central Government have also been empowered to grant exemption to certain companies from the provisions of the Act prohibiting creation of Secret Reserves, but it is done in public interest only

The following provisions of the Act prohibit a company from creating Secret Reserves

(*i*) The aggregate of any amounts set aside to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made up or any amount withdrawn from such reserves must be shown in the Profit and Loss Account (Clause 3 para viii of the Schedule VI Part II) It implies that creation and utilisation of reserves should be properly shown in the Profit and Loss Account "The aggregate of the amount set aside to provisions made for meeting specific liabilities, contingencies, or commitments and the amounts withdrawn from such provisions," must be shown in the Profit and Loss Account (Clause 3 para ix of Schedule VI)

(*ii*) Part I of the Schedule provides that the aggregate amount provided or written off since the date of acquisition or valuation of fixed assets must be shown separately in the Balance Sheet It also requires that the aggregate amounts of different types of reserves —capital reserves, revenue reserves and provisions respectively— must be shown separately in the Balance Sheet.

(*iii*) Where (*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or (*b*) any amount retained by way of providing for any known liability, is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as provisions The amount of such excesses should be shown in the Balance Sheet [Schedule VI part III Para 7 (2)]

(*iv*) The Balance Sheet and Profit and Loss Account must exhibit a 'true and fair' view of financial position of the company and its profit or loss (Section 211) Any method formerly adopted

for the creation of Secret Reserves would defeat the provisions of this section

Prior to the Companies Act, 1956 the position of an auditor with regard to the secret reserves was very awkward He had to face critical as well as ethical problems as the opinions on the subject were quite conflicting The different provisions of the Act mentioned above have set all the controversies in this respect at rest

AUDITOR'S DUTIES

Duties of anditor regarding various kind of reserves and fund are as follows

1 **Regarding Reserves** In respect of reserves created with a view to meet specific probable losses, e g , Reserve for Bad and Doubtful Debts and for Discounts etc , the auditor's duty is to see that adequate provision has been made If in his opinion the provisions are not sufficient for the purpose, he should not hesitate in reporting the matter He may be held liable for not reporting to the shareholders the unsatisfactory state of debtors [1]

2 **Regarding Reserve Fund.** So far as Reserve Fund is concerned, it is not the duty of the auditor to insist upon its creation Adequacy or otherwise of the Fund is a matter of financial policy with which he has nothing to do However, if a company in its Articles of Association specifically provides for the creation of Reserve Funds, he should see that it has been duly observed and carried out

3 **Regarding Sinking Fund** The auditor should be silent on the necessity or otherwise of the creation of Sinking Fund also A company is under no legal obligation to create such Funds But if the Articles of Association of the company contain any provision in favour of creating such Funds his duty is to see that this has been duly complied with He should further see that adequate annual charge has been made for the purpose To avoid any confusion or misinterpretation the investments held for the Sinking Fund should be clearly shown in the Balance Sheet separately from other usual types of investment

4 **Regarding Capitalisation of Reserves.** With regard to the capitalisation of revenue reserves, the auditor must see that the Articles of Association contain provisions in this respect If it is not so, he must see that such capitalisation has been resorted to after the necessary alterations of the Articles by special resolution He should also see the Minutes regarding the resolutions passed in this connection Thus, he should satisfy himself that all the legal formalities have been duly observed.

1 *Re London and general Bank* (1865)

5. Regarding Secret Reserves With regard to the Secret Reserves, if any, he should mention it in his report otherwise he will be failing in his statutory duties In case of financial companies such as banking and insurances companies, where the creation of such reserves is not prohibited legally, he must review the whole situation carefully He must ascertain the object of their creation If he finds that such Reserves have not been created with a *bona-fide* purpose or are far in excess of the legitimate requirements, he must disclose this fact in his report However, he must apply his own discretion intelligently and carefully

QUESTIONS

1 Classify various kinds of reserves and funds and explain them briefly Discuss the auditor's duty with regard to them.

2. What do you understand by 'provisions' and 'reserves'? Distinguish between them clearly and explain auditor's duty regarding them

3 What do you understand by Sinking Funds ? What are its kinds ? Explain auditor's duty with regard to sinking funds

4 What is a secret reserve ? How it is created ? Explain its merits and demerits and auditor's duty in this connection

5 Distinguish between the revenue and capital reserves. Explain auditor's duties regarding capital reserves

6 What is a capital reserve ? How it is created and explain auditor's duty regarding it

7 Define secret reserve Explan the provisions of the Companies Act, 1956 regarding it and explain the auditor's duty regarding such reserve

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Preliminaries to the Audit of Limited Companies

The company from of business organisation occupies today a dominant position Most of the joint stock companies are carrying on business on a very large scale Their accounts are subjected to compulsory audit by the statutes in the various countries of the world The inherent complex nature and constitution of a company necessitates the compulsory audit of its accounts since the shareholders, the real proprietors, are in general the absentee owners of the company They invest the capital and vest the management and control of the company in the hands of directors Individually, every shareholder is not in a position to ascertain whether the capital invested by him in the company is properly utilised by the directors or misappropriated by them foi their private gains. The directors, being in complete control of the company, are in a position to misutilise these funds To prevent this, the law has come to the rescue of the shareholders by providing adequate protection to them through various provisions including the compulsory audit of comyany accounts.

An independent professional auditor, with requisite ability and experience, conducts the audit of the books and accounts of the company on behalf of the shareholders by thoroughly examining them and reporting thereon He brings to their notice the fact whether the directors are carrying on the affairs of the company well or there is any irregularity on their part He ensures that the legal provisions have been duly complied with and the Balance Sheet uand the Profit and Loss Account have been drawn in the manner required by law and exhibit the true and fair view of the state of financial affairs and earnings of the company He also makes sure that the company did not enter into any business transactions without appropriate sanction or authority. He tries to detect and prevent frauds, errors and other irregularities on the part of the employees of the company. It has been aptly stated that "In fact, an examination of the affairs of the company by an independent agency like the auditor is practically the only saeguard which the shareholders have against the enterprise being carried on in an unbusiness like manner or their money being misapplied or misappropriated without their knowing that it has been so done."[1]

1 *Dy. Secretary to Government of India, Ministry of Finance v S N Das Gupta*

CONSIDERATIONS BEFORE COMMENCEMENT OF AUDIT

An auditor has to consider several points before actually starting the audit of a business concern We have already mentioned in a previous chapter about the general considerations before commencement of an audit, but those considerations are not enough in case of a company audit The auditor has to keep in mind several other points before actually commencing the audit of books and accounts of a company We discuss them below in detail

1 **Appointment of Auditor**[1] It should be noted by the auditor that all the legal provisions with regard to his appointment have been duly complied with and his appointment is in order In the case of a new company he should obtain a copy of the directors' minute regarding his appointment, as the first auditor is appointed by the directors If appointed in the general meeting of the company, he should obtain a copy of the resolution dealing with his appointment In case he has been appointed in place of a retiring auditor, he should find out that due notice was given to the retiring auditor in this connection He should also ascertain that a notice of intending nomination was duly given to the company If his appointment is to fill a casual vacancy, he should obtain a copy of the minutes of the Board of Directors to ensure that his appointment is in order But if the casual vacancy is due to the resignation of an auditor he should obtain a copy of the resolution passed at the general meeting making his appointment To avoid any breach of professional misconduct, he should communicate with the previous auditor enquiring the circumstances under which he retired and whether it would be proper for him to accept the appointment On receipt of the appointment letter, he should inform the Registrar in writing about his acceptance or refusal of the appointment within thirty days of the receipt of such letter He is also required to give a written certificate to the company that his appointment or re appointment is in accordance with the limits specified in the Companies Act, 1956

2 **Considerations regarding his remuneration** He should ascertain that his remuneration has been duly fixed by the proper authorities in accordance with the provisions of the Act If he has to act as first auditor of the company, his remuneration is usually fixed by the directors when the audit is completed Otherwise, it has to be fixed in advance in the general meeting of the company by the shareholders

In case the auditor has been called upon to do some work other than that of auditing, he should arrange to fix the fees for it separately, as it is no part of his duty as an auditor

He should see that the fees paid to him as auditor should be distinguished from the fees paid to him in any other capacity and must accordingly be shown in the Profit and Loss Account separately, as required by the Act

1 This has been discussed in detail in the Chapter "The Auditor" Here the relevant points are briefly given

3 Inspection of Books and Documents of the Company An auditor must inspect and study various documents and books of the company before he actually commences the audit He should obtain their list and examine the following documents very carefully

(1) *Memorandum of Association* It is undoubtedly the most important document of the company and the auditor must examine the following points very carefully.

(*a*) The object clause The company cannot carry on any transaction which is not within the scope of the object clause Any transaction not covered by the object clause would be *ultra vires* and the auditor must draw attention of the shareholders to this aspect through his report to them If he does not pay attention to this and such transactions have taken place, he would be held liable for the same It is to be noted that the Companies (Amendment) Act, 1965 provides that in the case of a company in existence immediately before the commencement of the Amendment Act, the objects of the company shall be stated in it. In case of a company formed after such commencement, it should state the main objects of the company to be pursued in its incorporation and objects incidental or ancillary to the main objects And in the case of companies (other than trading corporations) with objects not confined to one State, it should mention the State to whose territories the objects extend

(*b*) The capital clause A company cannot issue capital beyond the authorised capital mentioned in its Memorandum of Association The company after completing the legal formalities may increase the amount of authorised capital, and if it has been done, the auditor should obtain a copy of the resolution authorising the increase He should also see that the company has issued only Equity and Preference Shares and no other types of shares since they are prohibited by the Companies Act, 1956

(2) *Articles of Association* There are several important matters in the Articles of Association of the company which must be very carefully examined as they affect the working of the company to a great extent He should scrutinise the following points of the Articles

(*a*) The issue of share capital and its sub-division into different classes of shares and rights attached to each class of shares

(*b*) The provisions with regard to forfeiture, reissue of forfeited shares, transfers, and lien on the shares.

(*c*) Making calls on shares, interest on calls on arrears, and on calls paid in advance

(*d*) Payment of underwriting commission and brokerage on procuring allotment of shares

(*e*) The minimum subscription without which the directors cannot allot the shares

(*f*) Power to reorganise the share capital.

(*g*) Payment of interest out of capital in certain cases

(*h*) Power of borrowing funds

(*i*) Provisions with regard to the maintenance and audit of accounts, appointment, remuneration, rights and duties of auditor in addition to the statutory rights and duties

(*j*) Procedure for declaration of dividends, ascertainment of profits and transfers from and to reserve, power to declare the interim dividends

(*k*) Appointment, remuneration, number, qualifications and the power of directors of the company and also those of the Managing Director, Manager etc

(*l*) Proceedings and powers of the Board of Directors

(*m*) Rights of the members *inter se*

(*n*) Procedures with regard to Meetings etc

In the absence of the Articles of Association of the company, Table A of the Companies Act, 1956 will apply The auditor should study the regulations of Table A adopted by the company He should also find out whether any alteration has been made in the Articles of Association of the company If it is so, he should examine the special resolution passed for the purpose

(3) *The Prospectus* In case of the first audit of the company, the auditor must carefully examine the details of the Prospectus, if issued It is, however, not necessary to go through its details in subsequent audit The auditor's duty in this connection is limited to examination of the companys' records to ascertain that the various conditions given in the Prospectus issued have been duly complied with and there is no misstatement of facts It is on the basis and the faith of the Prospectus issued that the investors purchase shares of the company, but the auditor is not liable for any misrepresentation made in the Prospectus (Section 62)

(4) *Contracts* The auditor should inspect and examine all the contracts entered into with the vendors of third parties with regard to the purchase of property, payment of commission or the preliminary expenses He should see that the directors have already passed a resolution to that effect The auditor may take down notes of important clauses from these contracts for future references.

(5) *Certificate of incorporation and commencement of business* It must be examined in case of the first audit to ensure that the company has been duly incorporated and registered It is to be noted that a certificate of incorporation given by the Registrar of Companies in respect of any company shall be conclusive evidence that all the requirements of the Act in respect of registration and of matters precedent and incidental thereto have been complied with and that the company is duly registered under the Act It is after incorporation that the company becomes a separate legal entity quite distinct from the shareholders composing it.

(*x*) Appointment of sole selling agents.

(*xi*) Any other matter requiring authorisation in the general meeting by the shareholders of the company

(*b*) Directors' Minute Book An auditor should refer to and examine it for the following purposes

(*i*) Approval of material contracts

(*ii*) Appointment of various officials of the company and terms of their services

(*iii*) Allotment, making calls, forfeiture, reissue of forfeited shares etc

(*iv*) Appointment of the first auditor.

(*v*) Borrowing or advancing of loans

(*vi*) Appointment of the bankers to the company

(*vii*) Adoption of the accounts, declaration of dividends, appropriation of profits, transfer to reserves etc , and the payment of interim dividends

(*viii*) Authority for the use of the company's seals

(*ix*) Investment of the company's funds

(*x*) All other extraordinary transactions

(8) *A statement about the system of Internal Check* An auditor should obtain a written statement about the system of internal check in use in the company It is very essential since the audit of company accounts would depend to a very great extent upon the system of internal check in use

4 **Sanction of the Central Government** An auditor should ascertain whether the company has obtained necessary prior sanction from the Central Government, wherever it is required under the Companies Act, 1956, otherwise the transactions would become illegal In case of the following transactions, prior sanction of the Central Government is necessary

(*i*) Issue of shares at a discount of the more than 10 per cent (Section 79)

(*ii*) Issue of share warrants (Section 114)

(*iii*) For the increase in the minimum remuneration of fifty thousand rupees to the management in case of absence or inadequency of profits (Section 198)

(*iv*) Payment of interest on capital out of capital (Section 208)

(*v*) Advancing loans or giving any guarantee or providing any security in connection with a loan made by any other person to directors etc , directly or indirectly (Section 295)

(*vi*) Increasing the remuneration of the managing director on appointment or reappointment after the commencement of this Act (Section 311)

(*vii*) Payment of additional remuneration to managing agents (Section 352)

(*viii*) Investment in the shares of any body corporate in excess f the prescribed percentage (Section 372)

(*ix*) Continuing to hold existing investment by a company in ny other body corporate in the same group beyond the prescribed imit (Section 373)

5 **Enquiry about the kind of company** The auditor must nquire about nature and kind of company which he is going to audit t is necessary as the provisions of the Companies Act differ in case of a public company and a private company Similarly, it would be necessary for him to ascertain whether the company is a holding company or a subsidiary company He should specially note down he provisions of Section 43A of the Act because under this section a private company may become a public company under certain circumstances

QUESTIONS

1 You have been appointed auditor of a company What points would you consider before actually starting audit work ?

2 As a company auditor, what books and documents you would like to inspect regarding your audit ?

3 What are Minute Books ? With what purpose, a company auditor should refer to them ?

4 What are the transactions which require prior sanction of the Central Government ?

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Company Books of Account and Prospectus

BOOKS OF ACCOUNT

The Companies Act, 1956 does not expressly provide as to what particular books of account a company should maintain But under section 209 it provides that every company must keep *proper books of account* in respect to—

(*a*) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place ,

(*b*) all sales and purchases of goods by the company ,

(*c*) assets and liabilities of the company , and

(d) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

Negatively, it has been provided that proper books of account shall not be deemed to be kept with respect to the matter specified therein, if there are not kept such books are necessary to give a true which and fair view of the state of affairs of the company or branch office [Section 209 (3)]

The books of account must be kept at the registered office of the company or at such other place in India as the Board of Directors may decide The Board, however, has to file with the Registrar of Companies a notice giving the full address of that other place within seven days of such decision of keeping books at a place other than the registered office of the company Such notice of change should be given in Form No 23A of the Companies (Central Government's) General Rules and forms, 1956 We give the Form below

Registration No of Company... Nominal Capital Rs . ...

The Companies Act, 1956
Notice of address at which books of
account are maintained
Pursuant to proviso under Section 209 (1)

Name of Company .. . .Limited/Private Limited

Presented by

Limited/Private Limited hereby gives you notice pursuant to the proviso to sub section (1) of section 209 of the Companies Act, 1956, that the Board of Directors of the company have decided vide resolution dated the day of 19 to keep the books of account of the company at the following address

(Give full address) Signature
Designation*

Dated the day of ... 19

If the company has a branch office, whether in or outside India, the proper books of account relating to the transactions affected at the branch office should be kept there and a summarised returns made up-to-date at intervals of not more than three months must be sent by it to the company at its registered office or any other place where the company's books of account are kept

A company is also under legal obligation to maintain stock sheets or statement of annual stock takings, where the business of the company has involved dealings in goods (Section 541) If this provision is not complied with, it shall be deemed that the proper books of account have not been kept

It is further required that the books of account of every company relating to a period of not less than eight years immediately preceding the current year together with the vouchers relevant to any entry in such books of account shall be preserved in good order [Section 209 (4) (a)] In case of a company which is incorporated less than eight years before the current year, the books of account for the entire period preceding the current year shall be so preserved

The books of account are open to any director during business hours They may be open to inspection by the Registrar or any other officer authorised by the Central Government on its behalf provided that such inspection is made without giving any previous notice to the company or any officer thereof The Registrar or such officer may, during the course of inspection, make or cause to be made copies of books of account and other books and papers , place or cause to be placed any marks of identification thereon in token of

*State whether Director, Managing/whole-time Director, Manager or Secretary

the inspection having been made It is further provided that in order to enable the Registrar or such officer to make an inspection, of the books of account and other books and papers of the company, it shall be the duty of the company—

(i) to produce such books of account and other books and papers of the company as the Registrar or such officer may require,

(ii) otherwise to give to the Registrar or such officer all reasonable assistance in connection with the inspection [Section 209 (4) (a)]

Ordinarily, the books of account are not open to inspection by the members of the company unless so authorised by the Articles of Association The members, however, may get this right to inspect the books of account by passing a resolution in the general meeting It is to be noted that clause 95 of Table A provides with regard to the inspection of books of account and documents of the company by its members, and the directors are required to declare the time, place, and conditions required to be fulfilled by the shareholders for their inspection

A holding company has also got the right to inspect through its representative the books of account kept by its subsidiaries. Section 214 provides that a holding company may, by resolution, authorise representatives named in the resolution to inspect the books of account kept by any of its subsidiaries and the books of account of any such subsidiary shall be open to inspection by those representatives at any time during business hours

The directors are primarily responsible for the maintenance of the books of account of the company On default, they may be punishable with imprisonment for a term which may extend to six months, or with a fine which may extend to one thousand rupees, or with both [Section 209 (5)]

Section 541 lays down that in case of a company which is being wound up, if the proper books of account were not kept by it throughout the period of two years immediately preceding the commencement of the winding up, or the period between the incorperation of the company and the commencement of the winding up, whichever is shorter, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year But he will not be punishable if he shows that he acted honestly and that in the circumstances in which the business of the company was carried on the default was excusable The section further explains that it shall be deemed that proper books of account have not been kept if there have not been kept such books of accounts as are necessary to exhibit and explain the transaction and financial position of the company, including books containing entries made from day to day in sufficient detail of all cash received and all cash paid Also, where the business of the company has involved dealings in goods, statements of the annual stock-takings and (except in the case of goods sold by way of ordinary retail trade) all the goods so

sold and purchases, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified

STATUTORY BOOKS AND REGISTERS

Besides the books of account which have to be maintained by a company, it is required by the Act that every company should also keep other specified books and registers They are called statutory books and registers as the companies are under statutory obligation to keep them compulsorily Following is the list of such books and registers

1. *Register of investments* made by the company but not held in its own name and to record in it

(*a*) the value, nature and such other particulars as may be necessary fully to identify the shares and securities in question, and

(*b*) the bank or person in whose name or custody the shares or securities are held [Section 49 (7)]

2 *Register of charges*, entering therein all charges specifically affecting property of the company and all floating charges on the undertaking or property of the company (Section 143)

3 *Register of members* with the following particulars

(*a*) the name and address and the occupation, if any, of each member,

(*b*) shares held by each member, distinguishing each share by its number, and the amount paid or agreed to be considered as paid on those shares,

(*c*) the date at which each person was entered in the register as member, and

(*d*) the date at which any person ceased to be a member (Section 150).

4 *Index of members* of the company, if the company has more than fifty members, unless the register of members is in such a form as will in itself constitute an index (Section 151)

5 *Register and Index of debenture-holders* with the following particulars

(*a*) the name and address and the occupation, if any, of each debenture holder ,

(*b*) the debentures held by each holder, distinguishing each debenture by its number and the amount paid or agreed to be considered as paid on those debentures ,

(*c*) the date at which each person was entered in the register as a debenture-holder , and

(*d*) the date at which any person ceased to be debenture-holder.

If there are more than fifty debenture-holders, an index of debenture-holders shall be maintained unless the register is in such a form as in itself to constitute an index (Section 152)

6 *Foreign register of members or debenture-holders* which can be maintained by company, if so authorised by the Articles, in any country outside India, provided it is a company which has a share capital or which has issued debentures (Section 157)

7 *Minute books*, which must be kept by every company to record the minutes of proceedings of all general meetings, or meetings of the Board of Directors or of the committee of the Board (Section 193)

8 *Register of contracts*, with companies and firms in which the directors of the company are interested Every company shall keep such register to enter separately particulars of all contracts entered into with the company or firm in which the directors are interested It should include the following particulars

(*a*) the date of contract or arrangement ,
(*b*) the name of the parties thereto ,
(*c*) the principal terms and conditions thereof ,
(*d*) the date on which it was placed before the Board, and
(*e*) the names of the directors voting for and against the contract or arrangement and the names of those remaining neutral (Section 301)

9 *Register of Directors*, recording full particulars about them (Section 303)

10 *Register of Directors' Share-holdings etc* , showing therein the number, description and amount of any share in or debentures of, the company or any other body corporate, being the company's subsidiary or holding company or a subsidiary of the company's holding company (Section 307)

11 *Register* with particulars of appointment of managing agent or his associate as selling agent of goods producing by the company (Section 356)

12 *Register* with the particulars of the appointment of managing agent or his associate to procure business from outside India, in case of a company whose business consists of the supply or rendering of any services (Section 357)

13 *Register* about the appointment of managing agent or his associate as buying agents for the company (Section 358).

14 *Register* showing the particulars of every contract made between the managed company and third party where the managing agent of a company or his associate is buying or selling agent of a third party, and is in receipt of commission from such third party in respect of goods supplied or services rendered by such third party to the managed company (Section 359).

15 *Register* with the particulars of contracts between a company and its managing agent of his associate for the sale, purchase or supply of any property, movable or immovable, or for the supply or rendering of any service other than that of managing agent, or for the underwriting of any shares or debentures to be issued or sold by the company (Section 360)

16 *Register* of loans made, guarantees given or securities provided to companies under the same management It should show—

(*a*) the names of all bodies corporate under the same management as the lending company and the name of every firm in which a partner is a body corporate under the same management, and

(*b*) the following particulars in respect of every loan made, guarantees given or security provided by the lending company—

(*i*) the name of the body corporate to which the loan has been made whether such loan has been made before or after that body corporate came under the same management as the lending company,

(*ii*) the amount of the loan,

(*iii*) the date on which the loan has been made,

(*iv*) the date on which the guarantee has been given of security has been provided in connection with a loan made by any other person to, or to any other person by, any body corporate of firm referred to in sub-section (1) or (1A) together with the name of the person, body corporate or firm (Section 370)

17 *Register of Investments* made by the company in shares and debentures of other companies, showing in respect of each investment the following particulars

(*a*) the name of the body corporate in which the investment has been made,

(*b*) where the body corporate is in the same group as the investing company, the date on which the body corporate came in the same group, and

(*c*) the names of all bodies corporate in the same group as the investing company (Section 372)

Auditor's Duty So far as an auditor is concerned, he has nothing to do with the maintenance of such books It is the duty of the directors to see that the proper records are maintained Of course, the auditor may have to refer to these books from time to time in the course of his audit whenever he may need them He has a right to have access to and inspect any of the statutory books and registers If it comes to his knowledge that the statutory books do not contain the required informations, he may draw the attention of the directors

towards it His duty is to report to the members "whether, in his opinion, proper books of account as required by law have been kept by the company so far as it appears from the examination of those books, and proper return adequate for the purposes of this audit have been received from branches not visited by him" (Section 227)

THE PROSPECTUS

A public company must issue a Prospectus or file a Statement in lieu of Prospectus, before it can allot its shares to the share applicants A Prospectus must contain all the statutory informations required under the Act It should be dated and signed by the directors A copy of such Prospectus must be filed with the Registrar of Companies for registration as required under section 60 After the copy of the Prospectus has been filed with the Registrar for the purpose of registration, it should be issued by advertisement or otherwise within ninety days

The Registrar shall not register a Prospectus unless it is accompanied by the consent in writing of the person, if any named therein as the auditor of the company or intended company, to act in that capacity [Section 60 (3)]

The auditor should see carefully that the facts mentioned in the Prospectus are in conformity with the provisions of the Articles of the company and that of the Act, specially in connection with the following matters

(*i*) The application, allotment and call amounts payable on equity and preference shares separately

(*ii*) Preliminary expenses.

(*iii*) Minimum subscription

(*iv*) Underwriting commission and brokerage.

(*v*) Various contracts, including material contracts

(*vi*) Qualifications and remuneration of the directors, and their interest in the company

(*vii*) Appointment and remuneration of managing agent or managers

(*viii*) Issue of redeemable preference shares

The auditor should see that the conditions for allotment given in the Prospectus have been duly complied with His duty is limited only to the examination of the company's records and ensuring that the various conditions laid in the Prospectus have been observed However, he cannot be held liable for misrepresentation in the Prospectus (Section 92)

Auditor's Report An auditor has to give his report which will be included in the Prospectus as required under Schedule II, Part II of the Act A report by the auditors has to be set out in respect to

1. (*a*) profits and losses and assests and liabilities, in accordance with sub-clause (2) or (3), as the case may require , and

   (*b*) the rates of dividends, if any, paid by the company in respect of each class of shares for each of the five financial years immediately preceding the issue of the Prospectus and particular of the cases in which no dividends have been paid in respect of any class of shares for any of those years, and, if no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the Prospectus, containing a statement of the fact

2. If the company has no subsidiaries, the report shall ·

   (*a*) deal with the profits of losses of the company (distinguishing items of a non-recurring nature) for each of the five financial years immediately preceding the issue of the Prospectus, and

   (*b*) deal with the assets and liabilities as the last date to which the accounts of the company were made up.

3. If the company has subsidiaries, the report shall include the following information about the subsidiary companies

   (*a*) Apart from the holding company's profits and losses, either the combined profits and losses of all the subsidiaries so far as they concern members of the company The auditor has also an option to show the profits and losses of the group as a whole, i e profits/losses of the company plus combined profits/losses of subsidiaries so far as they concern the members of the company

   (*b*) Apart from the assets and liabilities of the holding company, the assets and liabilities of the subsidiaries as a whole with or without the holding company's assets and liabilities or individually of each subsidiary together with the allowance to be made for persons other than members of the company

If the proceeds of the issue of shares are to be applied directly or indirectly in the purchase of any business·as respects either the capital or profits and losses or both, in such business exceeding fifty per cent thereof, he must report upon

(*a*) the profits or losses of the business for each of the five financial years immediately preceding the issue of Prospectus , and

(*b*) the assets and liabilities of the business at the last date to which the accounts of the business were made up, being a

date not more than one hundred and twenty days before the date of the issue of the Prospectus.

Similarly, if the proceeds of the issue of the shares are to be applied directly and indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate, as a consequence of which that body corporate will become a subsidiary of the company, he must report upon

(*i*) the profits or losses of the other body corporate for each of the five financial years immediately preceding the issue of the Prospectus , and

(*ii*) the assets and liabilities of the other body corporate at the last date to which its accounts were made up

The Report shall also

(*a*) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company has at all material times held the shares to be acquired , and

(*b*) where the other body corporate has subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-clause (3) of clause 24 of this Schedule in relation to the company and its subsidiaries

In short, an auditor of the company shall state the following points in his report

(*i*) The profits or losses made during each of the preceding five years

(*ii*) The rate at which the company paid dividends on each type of shares during each of the preceding five years.

(*iii*) The sources from which the dividends have been paid

(*iv*) If no dividends have been paid on any class of shares for any of those years, their particulars have to be given

(*v*) Whether the accounts of the company have been made up to a date within three months from the date of the Prospectus

(*vi*) The position of all the assets and liabilities of the company as at the last date when its accounts were prepared

The auditor should examine the accounts of the related years carefully It has been rightly emphasised that "The statements of profits in the Prospectus and in the report of the auditor must in each case clearly set out the *Trading Results* of each year and all

charges and expenses incidental thereto, but must exclude non-trading profits, and profits of a non-recurring nature It must, however, include profits appropriated towards taxation or reserves "[1] He must make certain adjustments in respect of various items of non-recurring nature before he sets out to give his report For example, he may find that there has been some material change in the accounting principles during the period under consideration, or there has been abnormal business profits earned not in the normal course, or some material expenses not expected to recur, or the depreciation has been provided not in the prescribed manner, etc If it is so, he must draw the attention of the members with regard to these points by mentioning the facts in his report He must exercise his discretion, skill and sound judgment and disclose the various necessary adjustments and facts very carefully He should mention only the facts in his report and should avoid inclusion of any estimate or opinion about the future earning or prospects of the company. It is essential because the investors will depend to a great extent upon the report which he sets out in the Prospectus.

QUESTIONS

1. What are the statutory books and registers, which are required to be maintained by a company under the companies Act, 1956? Explain the auditor's duty in that connection
2. What is a Prospectus? On what points should an auditor pay special attention?
3. In what respects, a company auditor should give his reports to be included in the Prospectus?

1. J R Batliboi, *Principles and Practice of Auditing*, p. 140.

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Share Capital Transactions

The Companies Act, 1956 permits the issue of only two classes of shares by a company formed after the commencement of the Act—preference shares and ordinary or equity shares. It restricts the issue of deferred or founders shares But the provisions of the Act do not affect those shares which were issued before the commencement of the Act It is, therefore, essential to make a distinction between the shares issued before the commencement of the Act and those which were issued thereafter.

The thorough examination of the share capital transactions arises mainly when a company issues capital at its formation, or later on to increase its paid-up capital Subsequently, when the fresh issue of capital is not made by the company, the auditor has not to bother much for the detailed examination of such transactions It will then be enough for him to verify the transfer of shares registered at the end of each year, and check the total number and value of shares held by the shareholders with the help of the Share Register.

But before the auditor sets out to audit the share capital transactions he should note down the following points carefully

(1) Enquire about the *internal check* over the amounts received on account of issue of share capital.

(2) Study carefully the Memorandum of Association and Articles of the company as the conditions on which a company issues its shares are laid down in them

(3) In case of a public company, he should also see the Prospectus or Statement in lieu of Prospectus for the various terms and conditions mentioned therein.

(4) See whether the *consent of the Controller of Capital Issues* has been obtained, if necessary The provisions for the control on the issue of capital have been made in the Capital Issues (Control) Act, 1947 Unless it takes the consent of the Central Government, a company incorporated in India cannot (*i*) make an issue of capital (in or outside India), (*ii*) make in India any public offer of securities for sale, (*iii*) renew or postpone the date of maturity or repayment of any security maturing for payment in India

Those companies which issue capital up to 25 lakhs of rupees within a period of twelve months have, however, been exempted from

taking consent for the issue of share capital.

(5) Note the various *restrictions on a public company with regard to the allotment of shares* under the Act. They are as follows

(a) Under Section 69, no allotment shall be made of any share capital of a company offered to the public for subscription unless—

(*i*) the minimum subscription, stated in the Prospectus, has been received.

(*ii*) at least 5 per cent of the nominal amount of the shares has been received with the application on each share

(*iii*) all moneys received from application for shares are deposited and kept deposited into a scheduled bank until the certificate to commence business is obtained, or if such certificate has already been obtained until the entire amount payable on application for shares in respect of the minimum subscription has been received by the company

(*iv*) allotment is made within 120 days after the first issue of the Prospectus

(*b*) Under Section 70, a company having share capital which does not issue a Prospectus cannot allot any of its shares unless at least three days before the first allotment of the shares the company has delivered to the Registrar for registration a Statement in lieu of Prospectus in the prescribed form

(*c*) Under Section 72, no allotment can be made and no proceeding shall be taken on application by a company, until the beginning of the fifth day after the date on which the Prospectus is first issued or such later time, if any, as may be specified in the Prospectus

(*d*) Under Section 73, any allotment made will be void where (*i*) a Prospectus states that the application has been or will be made for permission for the shares to be dealt in a recognised Stock Exchange but the permission has not been applied for before the tenth day after the first issue of the Prospectus, (*ii*) or the permission has not been granted before the expiry of four weeks from the date of the closing of the subscription list or such longer period not exceeding seven weeks as may within the said four weeks be notified to the applicant for permission by or on behalf of the Stock Exchange

The *minimum subscription* as noted above implies the minimum amount which must be raised in cash out of issue of shares in order to provide for (*a*) the purchase price of any property purchase or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue, (*b*) any preliminary expenses payable by the company and every commission on shares payable by the company, (*c*) repayment of any moneys borrowed by the company in respect of the foregoing matters, (*d*) working capital, (*e*) any other

expenditure (Schedule II, Clause 5). The auditor should see that this provision has been duly observed

We now study the audit of various share capital transactions

Shares issued for Cash. While carrying out the audit of shares issued for cash, the auditor should follow the following procedure

(*i*) Check the original applications and copies of allotment letters with the records in Application and Allotment Book or Sheets

(*ii*) Check entries, in respect of application moneys received and deposited, in the Application and Allotment Book with entries in Cash Book and Share Ledger

(*iii*) Ascertain that the application moneys were deposited into bank in a separate account and no withdrawal from that was made for purposes of the business until according to section 149, a Certificate to commence business was obtained

(*iv*) Check the application moneys returned, if no allotment was made on those applications, with the copies of letters of regret and vouch it from the Cash Book into the Application and Allotment Book Also check the payee's acknowledgement receipts for the same

(*v*) Check the Director's Minute Book to ascertain that all the allotments of shares have been properly made in accordance with the provisions of the Act

(*vi*) Check the entries in the Cash Book for amounts received on allotment and compare them with the entries in the Application and Allotment Book Also check the postings into the Ledger

(*vii*) See that the shares issued and allotted are not more than the authorised capital as laid down in the company's Memorandum of Association

(*viii*) Ascertain whether the calls have been made on shares If so check the Director's Minute Book and vouch the entries in the Cash Book for calls with the help of the counterfoils of receipts Also check the postings into the Shares Ledger from the Calls Book and Cash Book

(*ix*) For calls received in advance, see that proper adjustment has been made for them and interest, if to be paid, has been duly credited

(*x*) See that the provisions, if any, with regard to the minimum subscription have been duly complied with

(*xi*) Ascertain that the sanction from the Controller of Capital Issues has been duly obtained, if necessary

(*xii*) Vouch the balances in the Register of Members to see that the total thereof tallies with the total number of share issued

(*xiii*) See that the return of allotments has been filed with the Registrar within one month of such allotment

(*xiv*) Ascertain whether permission has been granted by the Stock Exchange to deal in the shares of the company If the permission has been refused, ascertain that the application money have been repaid to the applicants, provided it was stated in the Prospectus that such permission was being sought for

Shares Issued for Consideration other than Cash The shares are usually issued for cash, but sometimes they are issued to the vendors or other persons for other considerations such as part payment of the assets purchased or services rendered to the company

Most of the procedures mentioned above in case of shares issued for cash, is also applicable in this case The auditor, however, has to adopt following special procedures regarding audit of shares issued for consideration other than cash

(*i*) Such allotment of shares is made on the basis of the contract entered into between the company and the allottee The auditor should vouch it by examining the contract He should also verify it with the help of the Director's Minute Book with regard to allotment of such shares issued for consideration other than cash

(*ii*) Sometimes such shares are issued to the persons in consideration of the payment of the preliminary expenses of the company by those persons This should also be examined with reference to the contracts entered into by the company in this connection and the Director's Minute Book In case the shares have been issued in consideration of the payment of the underwriting commission, it should be vouched in similar way

(*iii*) The auditor should also find out whether copy of such a contract in writing has been duly filed with the Registrar of Companies along with the return of allotment within one month of the allotment having been made as required by Section 75(1) (b) of the Companies Act, 1956 In case the contract is not in writing, its particulars must be filed with the Registrar But it should be duly stamped

(*iv*) The auditor should examine the prospectus to see the substance of contract and relevant terms of issue including mode of payment of purchase consideration or payment of commission to the underwriters or payment of preliminary expenses

(*v*) If any premium or discount is involved, he should see that appropriate adjustment entry has been passed in that connection

(*vi*) The Journal entries in this connection should be duly vouched with reference to the contracts and the Minute Book He should also inspect the Register of the Members to check the allotment of such shares

(*vii*) He should ascertain that the particulars of such shares issued for consideration other than cash have been disclosed in the Balance Sheet under the heading 'subscribed capital' separately

Redeemable Preference Shares An auditor should note that a company, limited by shares, may issue redeemable preference

shares if so authorised by its Articles Such redeemable preference shares may be issued as cumulative, non-cumulative or participating as might be provided in the Articles of the company He should ensure that provision of section 80 laying down four other conditions for the issue of such preference shares, have been followed He should ascertain that—

(a) no such shares shall be redeemed except out of profits of the company which would otherwise be available, for the dividend or out of the proceeds of a fresh issue of shares made for the purpose of the redemption ,

(b) no such shares shall be redeemed unless they are fully paid ,

(c) the premium, if any, payable on redemption shall have been provided for out of the profits of the company or out of the company's share premium account, before the shares are redeemed ,

(d) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, a reserve fund should be created out of divisible profits to be called the Capital Redemption Reserve Account The amount to be transferred to the Reserve shall be equal to the nominal amount of the shares redeemed This Fund cannot be reduced except in accordance with the rules relating to the reduction of share capital given in section 100 But this Fund can be utilised by the company in issuing the fully paid bonus shares.

It is to be noted by him that the redemption of the redeemable preference shares by a company does not in any case amount to the reduction in the amount of the authorised capital of the company.

The auditor should see that proper note has been given in the Balance Sheet under the head 'share capital' with regard to various terms and conditions for the redemption of such shares, specially the date on or before which they are liable to be redeemed

Shares Issued at a Premium An auditor should note section 78(1) of the Act, where a company issue a share at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called the Share Premiums Account

He should see that the amount of premium so received has been placed to the credit of the Share Premium Account and has not been transferred to the Capital or Capital Reserve Account

He should see that the Share Premium Account has been shown in the Balance Sheet as a separate item under the head "Reserves and Surplus" He should also ascertain that the amount of the share premium is utilised—

(a) in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares ,

(b) in writing off the preliminary expenses of the company ,

(*c*) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or the debentures of the company, or

(*d*) in providing for the premium payable on the redemption of any redeemable preferences share or of any debentures of the company [Section 78(2)].

The auditor should see that it is utilised in the manner given above and no dividend is paid out of it If it is done, it would have the effect of reducing the capital of the company which is prohibited

Shares Issued at a Discount While auditing the shares issued at a discount, the auditor has to see that the statutory provisions in this respect have been duly complied with He should note that ordinarily shares cannot be issued at a discount, but according to section 79 of the Companies Act, 1956, a company may issue its shares at a discount in the following circumstances only

(*i*) Such issue has been authorised by a resolution passed by the company in its general meeting, and sanctioned by the Court ,

(*ii*) The resolution should specify the maximum rate of discount which should not exceed 10% or such rate as the Central Government has permitted,

(*iii*) at the date of such issue, the company must have completed its one year since the date on which it was entitled to commence business , and

(*iv*) it should be issued within two months after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow

The auditor should pay attention to the fact that shares issued at a discount have been shown in the Balance Sheet as a separate item under the head "Miscellaneous Expenses " He should advise the writing off of such discount on shares as early as possible, though there is no legal obligation on the part of the company to do so.

Calls paid in Advance A company, if so authorised by its Articles, may accept from any member the whole or a part of the amount remaining unpaid on any share held by him, although no part of that amount has been called up [Section 92(1)]

An auditor should note that usually the Articles of the companies make provisions for the payment of interest on such calls received in advance Article 18 (b) of Table A also provides that upon all or any of the moneys so advanced the Board may pay interest at such rate note exceeding six per cent per annum, as may be agreed upon between the Board and the member paying the sum in advance The company may, however, change the rate in its general meeting

The auditor has to see that the provisions with regard to payment of the interest on calls paid in advance have been duly complied

with He should see that the interest is being paid at the rate of six per cent per annum or as fixed by the Board of Director together with such members or at the rate as authorised by the Articles of the company He should ensure that such interest should be charged to the Profit and Loss Account but in case there are no profits it may be paid even out of the capital The Act does not require the calls paid in advance to be shown separately though it may be desirable to show it separately in the Balance Sheet as it does not form part of the capital in the real sense In the event of winding up of the company, they are repayable with interest before any part of the called up capital is returned to the shareholders

Calls in Arrears It so happens that some members fail to pay the company within prescribed period on calls made by the company on the shares Such unpaid amounts are taken as calls in arrears The auditor should ascertain the total amount of such calls in arrears He should obtain a list of such arrears and check it with the Shares Ledger The debit balance on share allotment or Share Call Account in the General Ledger should agree with the total specified in the List He should further see that the interest due has been charged on such arrears if it has been so decided by the Board of directors in accordance with the provisions of the Articles of the company He should see that such arrears are shown in the Balance Sheet separately as provided in Part I of Schedule VI of the Act He should be careful in its examination, particularly when the arrears are due from the managing agents or secretaries and treasurers

Reserve Capital Reserve capital is a part of the subscribed capital which has not been called up and which is reserved to be called only in the extent of the winding up of the company An auditor should note that in its life time a company cannot call up its reserve capital He should further note section 99 of the Act which permits a limited company to reserve part of its capital But for this the company will have to pass a special resolution determining for the reservation of capital The auditor has to see that a resolution has been passed to that effect and it is not called up in the company's life-time

Issue of Share Warrants to Bearers An auditor should be familiar with the section 114 of the Act under which a public company, limited by shares, may issue a share warrant But it will have to obtain prior sanction of the Central Government for the same This document entitles the bearer of the warrant to the shares specified therein. The main feature of such a warrant is that it is transferable by delivery only. The company may also provide, by coupons or otherwise, for the payment of further dividends on shares specified in the warrant

The auditor's duty in this connection is to ascertain that the share warrants have been issued in accordance with the provisions of the Act He should see in particular that the sanction of the Central Government has been taken before the issue of such warrants He should also see that according to section 115, on the issue of a

share warrant the company has struck out of its Register of Members the name of the members to whom such warrants have been issued Besides, the names of such members have to be entered in the Register of Share Warrants with the following particulars

(*a*) the fact of the issue of warrants ,

(*b*) a statement of the shares specified in the warrant, distinguishing each share by its number, and

(*c*) the date of the issue of the warrant

Forfeiture of Shares The company may forfeit the shares on account of non-payment of calls by the members But this can be done if it has been so authorised by the Articles of the company and also in the manner prescribed in it

The auditor should verify the forfeiture of shares in the following manner

(*i*) Examine the Articles of the company for provisions to forfeit the shares and see that those provisions have been duly complied with Table A given in the Act also confers necessary powers on the Board to forfeit the shares after serving a notice for it.

(*ii*) See that on those shares, which have been forfeited, some calls or instalment of call or the interest was outstanding

(*iii*) Ascertain that due notice was given to the members with regard to the forfeiture of the shares

(*iv*) Inspect the Directors' Minute Book to find out whether a resolution had been passed to issue the notice as well as to forfeit the shares

(*v*) Check whether necessary entries have been passed in the books of account or not He should verify the correctness of those entries. It should be seen that the actual amount of cash received on account of the forfeited shares should be transferred to the credit of the Forfeited Share Account and it should be shown in the Balance Sheet as a separate item

(*vi*) Examine that the premiums received on the issue of shares have not been transferred to the Forfeited Shares Account

Reissue of Forfeited Shares The forfeited shares may be reissued by the company directors if the Articles of the company empower them to do so Usually the Articles do provide for the reissue of forfeited shares Clause 32 of Table A also contains provisions to this effect But such shares can be reissued in such a manner as it may not amount to reduction of capital since it is prohibited under section 100 of the Act Thus, the forfeited shares can be reissued only if a minimum amount has been received For instance, Mr X holds a share of Rs 10 with a paid-up value of Rs 5 A call of Rs 2 was made from him, who did not pay it.

The share was, therefore, forfeited In this case this forfeited share must not be reissued for less than Rs 5 and this would be the minimum amount Usually such shares are reissued with the amount which is in excess of such minimum If it is so, it would result into capital profit to the tune of such excess which should be transferred to Capital Reserve as given in Part I of Schedule VI of the Act It must not be transferred to the credit of the Profit and Loss Account

The auditor should verify the reissue of the forfeited shares in the following manner .

(*i*) Inspect the Directors' Minute Book to see that relevant resolution has been passed to reissue the forfeited shares

(*ii*) Verify the amount received on such issue and see that the amount received is not less than the minimum mentioned above

(*iii*) See that any capital profit on reissue of the forfeited shares has been transferred to the Capital Reserve Account only But in case any premium was received on the original issue of the forfeited shares, that premium should remain in the Shares Premium Account and should not be allowed to be transferred to the Forfeited Shares Account

(*iv*) Ascertain that proper and necessary entries have been recorded on the reallotment of shares and that the Forfeited Shares Account has been correctly dealt with and shown in the Balance Sheet The balance of the Forfeited Share Account will be shown as "Amount Received on Shares Forfeited" under the head "Share Capital" and it will be shown until such forfeited shares are reissued

(*v*) Verify whether the return of such allotment has been filed with the Registrar of Companies

(*vi*) In case such forfeited share have not been reissued but cancelled by the directors, he should vouch the cancellation by reference to the Directors Minute Book and the Register of Members

Issue of Share Certificates An auditor must see that provisions of section 113 of the Act providing for the issue of share certificates have been duly complied with This section provides that every company within three months after the allotment of any of its shares and within two months after the application for the registration of the transfer of any such shares must have ready for delivery the certificates of all shares, unless the conditions of issue of the shares otherwise provide He should be familiar with the Companies (issue of Share Certificates) Rules, 1960 which govern the issue of share certificates.

Alteration of Share Capital The auditor should see that share capital of a limited company has been altered only if the Articles of the company permit it to do so by a resolution passed in its general

meeting by the members There is no need for getting prior sanction of the Court

He should note that under section 94, a company may—

(*i*) increase its share capital by issue of new shares,

(*ii*) consolidate and divide its share capital into shares of larger amounts than the existing ones,

(*iii*) convert its fully paid shares into stock or vice-versa,

(*iv*) sub-divide its shares into shares of smaller amount,

(*v*) cancel its unissued shares

He should inspect the Shareholders Minute Book and ascertain that a resolution to that effect has been passed authorising such alteration He should also inspect the Directors Minute Book to examine the resolutions passed in connection with the allotments, consolidation, conversion or sub-division of shares etc

In case the share capital has been increased, he should see that such increase has been made by the issue of new shares and not by increasing the face value of the existing shares

It should be ascertained by him that due notice of such alteration has been given to the Registrar In case of increase of capital, the notice must be given within fifteen days after passing the resolution affecting such increase [section 97]. In all other cases of alterations of capital it must be given within one month after making such alteration (section 95)

Reduction of Share Capital A limited company may reduce its share capital by passing a special resolution, if so authorised by its Articles, and securing sanction from the Court for the same. The Memorandum of Association has also to be changed accordingly

The auditor should note that under section 100 a company may reduce its share capital—

(*i*) by extinguishing or reducing the liability on any of its shares in respect of share capital not paid up ,

(*ii*) by cancelling any paid-up share capital which is lost or is unrepresented by available assets , or

(*iii*) by paying off any paid up share capital which is in excess of the needs of the company

He should note that according to section 101, where a company has passed a resolution for reducing share capital, it may apply to the Court for an order confirming the reduction The Court may make an order confirming the reduction on such terms and conditions as it thinks fit The Court may also order the company to add to its name the words "and reduced" for the period as may be specified in its order (section 102)

Further, section 103 requires the registration of order and

minute with prescribed details approved by the Court The Registrar shall register the order and minute and shall certify their registration, and his certificate will be the conclusive evidence that all the requirements of the Act in this connection have been complied with The reduction of share capital can take place only after such registration It is to be noted that a company cannot reduce its capital by purchasing its own shares

The auditor's duties in this connection are as follows:—

(*i*) He should find out whether the Articles of the Company contain a provision for reduction of share capital

(*ii*) It should be ascertained by him that the various provisions of the Act with regard to the reduction of the capital have been duly complied with, i e a proper meeting has been convened ; special resolution has been passed , order of the Court confirming such reduction has been obtained , and the Registrar has issued a Certificate of Registration of the order and the minutes etc

(*iii*) He should check that proper entries have been made in the books of account in this connection He should vouch it with reference to the resolution passed by the shareholders and other documentary evidences available

(*iv*) He should examine the basis of writing down of the assets to bring about the reduction of capital He should see that the amounts written off the fixed assets have been correctly stated and the basis of valuation of such assets has also been disclosed in the Balance Sheet of the company, According to Schedule VI of the Act, each Balance Sheet for the first five years subsequent to the date of reduction shall also show the amount of the reduction made

(*v*) In case the Court has given order to add "and reduced," the auditor should see that in the Balance Sheet these words have been added to the name of the company for the specified period

(*vi*) He should examine the Register of Members to ascertain that the alterations necessitated by the reduction of capital have been made therein

Further Issue of Capital While auditing the share capital transactions of a company, the auditor will have to see that provisions under section 81 of the Act with regard to the further issue of capital have been complied with According to this section if a company wants to issue further shares, it can do so after the expiry of two years from the formation of the company or at any time after the expiry of one year from the allotment of shares in that company, whichever is earlier Such further shares shall be offered to the persons who, at the date of the offer, are holders of the equity shares of the company, in proportion as nearly as circumstances admit, to the capital paid up on those shares at that date Such offer shall be made by notice specifying the number of shares offered and limiting a time not less than fifteen days from the date of the offer

within which the offer, if not accepted, will be deemed to have been declined On the decline of shares offered, the Board of directors may dispose them in such manner as they think most beneficial to the company

Such shares may be offered to other persons also but for this the company will have to pass a special resolution If no special resolution is passed, it can be done when the majority of members voted for this and the Central Government is satisfied on an application made by the Board of directors that the proposal is most beneficial to the company

The provisions of the section are not applicable to a private company or for increasing the subscribed capital of a public company caused by exercise of an option to debentures issued or loans raised by the company to convert such debentures or loans into shares in the company, or to subscribe for shares in the company

Audit of Share Transfers The shares of a company are transferable just as any other immovable property which can be legally transferred A company may allow transfer of shares in the manner prescribed in its Articles But normally, it is not an auditor's duty to audit transfer of shares What he is required to do in the course of his annual audit is to see that the total of the balance in the Register of Members agrees with that of subscribed capital But he may be engaged by the Directors to carry on the audit of share transfers if the company's Articles so require or by some special arrangement The object of such audit is to impose a check against the clerical errors and the issue of duplicate certificates If an auditor is so engaged, he should obtain clear instructions from the directors about his duties and scope of work as the statute does not lay down his duties in this connection He will have to be paid special fee for this

The duties of an auditor in this connection are as follows ·

(*i*) Study the provisions of the Articles in this connection and see that they have been duly complied with

(*ii*) Enquire whether proper intimations were sent to each transferor, or each holder in case of joint-holders, and whether he had any objection against registration of the transfers Find out whether 'no objection' letter has been received from the transfer or the holder

(*iii*) See that in case of the transferor of partly paid shares due notice has been given to the transferee and the registration of transfer was made on the receipt of the 'no objection' letter from transferee within two weeks from the receipt of the notice as provided under section 110.

(*iv*) Ascertain that the provision of section 108 have been observed by the company while registering the transfer of shares Under this section, the company shall not register a transfer of shares unless a proper instrument of transfer duly stamped and executed by

or on behalf of the transferor and by or on behalf of the transferee and specifying the name, address and occupation, if any, of the transferee, has been delivered to the company along with the certificate relating to the shares or if no such certificate is in existence, along with the letter of allotment of the shares The Companies Amendment Act, 1965 seeks to impose restrictions on the period of currency of blank transfers Every instrument of transfer shall be in the prescribed form bearing the date of presentation stamped by the prescribed authority and the said instrument shall be delivered to the Company (*a*) in the case of shares dealt in or quoted on a recognised stock exchange at any time before the date of presentation of shares, and (*b*) within two months from that date in the case of any other shares

Under Companies (Amendment) Act, 1974 new sections 108 A to 108 H have been inserted They provide for restrictions on the acquisition of shares under specified conditions, restriction on the transfers by certain companies, restriction on the transfer of shares of foreign companies under the prescribed conditions, the power of Central Government to direct companies not to give effect to the transfer etc The auditor must keep in mind the provision of these sections also

(*v*) Examine the transfer forms and see that they are in conformity with the provisions of the Articles and bear the appropriate stamps

(*vi*) Vouch the transfer fee with total number of transfers lodged and see that it has been properly credited to the Profit and Loss Account

(*vii*) Compare the signature of the transferor with his specimen signature with the company

(*viii*) Ascertain whether the old share certificates have been cancelled to avoid their being reissued

(*ix*) Find out whether the transfers had been carefully examined by the office, specially to see that they have not been transferred to such person who may be disqualified from holding shares in the company. He should further see that every clerk, responsible for the registration of transfers, has affixed his signature on the documents he had verified

(*x*) Ascertain whether any lien existed on the shares transferred and if it is so, how that has been dealt with

(*xi*) Examine the Directors Minute Book to verify that transfers have been duly approved by the Board

(*xii*) See that proper entries have been made in the books of the company Vouch the entries in the Share Transfer Journal with the transfer forms He should specially note the name of the transferor, name and address of transferee and number and class of shares transferred Tick the transfer form once checked to avoid its being presented again

(*xiii*) Check the postings of such transfers and other particulars in the accounts of both the transferors and the transferees from the Transfer Journal into the Register of Members

(*xiv*) Refer to the Directors' Minute Book to check the issue of new share certificates to the transferees He should also examine the details on the counterfoils of such certificates

(*xv*) In the event of a transmission of shares, on death or brankruptcy of the holders, see—

(*a*) the Succession Certificate or Grant of probate or Power of Attorney ,

(*b*) the certificate issued by the Controller of Estate Duty to verify that the Estate Duty has been duly paid , and

(*c*) that the application has been received from the executor or legatee stating that the shares may be issued to him.

(*xvi*) In case the transfer of shares was refused, ascertain that a notice of refusal was sent to the person concerned within a period of two months

(*xvii*) Check the stock of unused share certificates, paying special attention to the serial number

QUESTIONS

1 As a company auditor, on what points you would pay your special attention before starting audit of share capital transactions ?

2 How would you, as a company auditor, undertake audit of share capital transactions ?

3 How would audit transfer of shares in a company ?

4 How would you audit shares issued for consideration other than cash ?

5 How would you audit (a) shares issued at premium (b) issue of forfeited shares ?

17

Debentures and Other Transactions

DEBENTURES

A Company may issue the debentures to raise funds, provided it is empowered to do so Such power may be express or implied But the debentures do not form part of the capital of the company The debenture-holders do not possess the proprietorship or the voting rights etc , but they do have the right to get payment of interest and the repayment of principal The debentures may be issued by the company with or without charge which may be fixed or floating They include debenture-stocks and bonds The debenture-holders are taken as the creditors of the company

A company must take the consent of Controller of Capital Issues, wherever necessary, if it wants to issue the debentures The Board of directors must pass a resolution authorising such issue of debentures If they are to be issued to the public, a Prospectus with all the statutory details should be issued and field with the Registrar of Companies In case the Prospectus has not been issued, Statement in lieu of Prospectus must be filed with the Registrar at least three days before the first allotment of the debentures If a charge on the property of the company is created by the issue of the debentures, the particulars of the charge must be filed with the Registrar within 21 days after the execution of the deed containing the charge

It should be noted that a meeting of the members must be called and by an ordinary resolution their consent must be obtained if the proposed borrowing through debentures together with the other borrowings already made by the company exceeds the aggregate of the company's paid-up capital and the reserves as given under section 293(1) (d) Money already borrowed for this purpose, however, would not include the temporary loans taken by the company in the ordinary course of its business The Companies Act, 1956 has restricted the issue of any debentures that carry voting rights at any meeting of the company With regard to the allotment of debentures, the Act has put the same restrictions as in the case of the allotment of shares which have already been discussed in detail in the previous chapter

Audit Procedure. The auditor should proceed in this connection as follows ·

(*i*) He should refer to the Memorandum and Articles of

Association of the company and see if any restriction has been put on the issue of debentures by the company. If it is so, he should verify that these limits have not been exceeded

(*ii*) He should examine the Directors' Minute Book to verify that each issue has been properly authorised

(*iii*) He should check in detail the applications for the debentures, their allotments and calls, if any, in the same manner as in the case of the issue of share capital For this purpose, he should refer to the Debenture Applications, Allotment and Calls Register and the Register of Debenture-holders

(*iv*) He must examine the contracts if the debentures have been issued to the vendors of the business as fully paid, specially when given in part payment of the purchase consideration

(*v*) He should vouch the moneys received and entered in the Cash Book with reference to the counterfoils of the receipts issued He may further refer to the Register of Debenture-holders for this

(*vi*) He should inspect the Trust Deeds and find out whether any remuneration is payable under it to the Trustees for the Debenture-holders If so, he should see that the payments have been made or provided for in the accounts.

(*vii*) He should sec that the balance on the Debentures Account in the General Ledger agrees with the total amount shown in the Register of Debenture-holders

(*viii*) In case the debenture hold a charge on the properties of the company, he should see that it has been recorded in the Register of Charges and also that it has been properly filed with the Registrar

(*ix*) If debts have been issued by way of Security for a loan, he should see that they have been clearly shown in the balance sheet

(*x*) The auditor should vouch the payment of all interest on it with reference to the debentures-holders, acknowledgements, endorsed warrants or coupons etc He should see that the interest has been paid whether there is a profit or not, and that it has been disclosed in the Profit and Loss Account of the company He should also verify that all the interests accrued on them have been brought into account and shown in the Balance Sheet as liability

(*xi*) He should ascertain that the debentures have been duly registered with the Registrar of Companies

The debentures may be issued at a premium, or at a discount, or at par but redeemable at premium, or as collateral security They are discussed below

Debentures Issued at a Premium Where the debentures have been issued at a premium, the amount of premium, so realised, would be in the nature of capital profit and the auditor should see that it has been transferred to the Premium on Debentures Account

and not to Debentures Account. He should ascertain that the amount of premium received on the debentures is to be utilised in the manner mentioned earlier in the case of premium on shares There is no specific provision in the Act as to how it should be dealt with It may be utilised for the redemption of the debentures, or writing off fictitious assets or the expenses of issuing the debentures If such premium has been transferred to the Profit and Loss Account, he must find out that it has been clearly disclosed in it and see that the Articles of the company do not impose any restriction in this connection

Debenture Issued at a Discount Sometimes a company may have to issue the debentures at discount because of its poor financial position or unfavourable situation of the money market If they are issued at a discount, the auditor should see that the total amount of the discount has been debited to 'Discount on Debentures Account' He should ascertain that the debentures appear in the Balance Sheet as liabilities at their *nominal* value and the interest is also payable on its nominal value and not at the discounted value The Discount on Debentures Account should appear on the asset side of the Balance Sheet from year to year until it has been completely written off From the point of sound financial policy, it is advisable that it should be written off within reasonable period The auditor should see that the provisions of section 76 (2) relating to payment of commission etc on them have been duly observed. They have been enumerated later in this chapter

Debentures Issued at par but Redeemable at Premium If the debentures, issued at par, are redeemable at premium, the auditor should see that such amount of premium has been debited to 'Loss on issue of Debentures Account,' and credited to 'Premium on Redemption of Debentures Account' The balance of loss on Issue of Debentures Account should be written off as in the case of discount on issue of debentures mentioned above He should ensure that the balance of the Premium on Redemption of Debentures Account should be carried forward as a provision till the period when the debentures are redeemed And when the debentures are to be redeemed, the balance on the account should be transferred to Debentures Account He should see that if a Redemption Fund has been created to redeem the debentures, the Fund should not only be credited with the nominal value of the debentures, but with the amount of premium also which will be required at the time of redemption of debentures If no Sinking Fund has been created for the same, it should be provided for out of profits over the term of the debentures

Debentures Issued as a Collateral Security Sometimes the company issues the debentures simply as a collateral or additional or secondary securities for loans already taken by the company from its creditors, usually the bankers It is taken as a collateral security since the amount of the debentures will not be payable until the company repays the loan at due date. As soon as the loan is repaid, the collateral security is automatically repaid As it is issued by way

of security, usually the nominal value of the debentures issued exceeds the amount of loan taken by the company But the liability of the company is restricted to the tune of the amount of loans and not to face value of debentures No interest is payable on such debentures and interest on loans is payable as usual No entries are also necessary in this connection. No money is received on the issue of such debentures by the company, hence it is not shown as the liability of the company The auditor should see that they are shown by way of note only under the liability concerned for which such debentures have been issued He should see however, that necessary entries in this connection have been made in the Register of Mortgages and that they have been properly filed with the Registrar

The debentures issued as a collateral security are released on the payment of the company He should see, that provisions of section 121 (4) of the Act in this connection have been observed It states that where a company has deposited any of its debentures to secure advantage from time to time on current account or otherwise, the debentures shall not be deemed to have redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remained so deposited

Redemption of Debentures A company may issue redeemable or irredeemable debentures Usually, the debentures are redeemable in which case the debenture-holders have to be paid back after the expiry of certain fixed period The auditor should inspect the Debentures or the Trust Deeds, if any, to find out the terms and conditions of redemption of the debentures. He should also refer to the Articles of Association of the company He should be sure that those terms and conditions are duly observed For the redemption of the debentures, Sinking Fund is usually created or a Sinking Fund Insurance Policy is taken by the company out of the profits from year to year They may also be redeemed by periodical or annual drawings from the Profit and Loss Account

He should vouch their redemption with the help of Debenture-Bonds cancelled He should also refer to the Director's Minute Book authorising the redemption of debentures The auditor should vouch the proceeds of sale of Sinking Fund Investments very carefully with reference to the Sold Note and see that the proceeds have been utilised properly He should check the entries in this connection in the books of account If there is any profit on the sale of the Sinking Fund investments, that may be available for distribution as dividends to the shareholders since the Fund is created out of the revenue

If the debentures have been redeemed in the open market and at a discount, the profit thereby made may be transferred to the Profit and Loss Account But it is advisable to transfer it to a general reserve Where the Sinking Fund was not created, the profit on redemption of debentures should not be transferred to the Profit and Loss Account but credited to the Reserves

Reissue of Redeemed Debentures The auditor should note the power given to companies under section 121 of the Act to reissue

the debentures which have already been redeemed They may be reissued either by reissuing the same debentures or issuing others in their place But under this section it can be legally done only if (*a*) Articles of the company provide nothing contrary, whether express or implied, in this regard, (*b*) it has not been restricted in the conditions of issue or in any contract entered into by the company, and (*c*) the company has not by passing a resolution to that effect or by same other act, manifested its intention that the debentures shall be cancelled

On the reissue of such debentures, the persons entitled to such debentures shall have the same rights and priorities as if the debentures had never been redeemed They will be treated in the same manner for the purpose of stamp duty also It is to be noted that a company can purchase its own debentures, but that should be properly shown in the Balance Sheet

So far as the auditor is concerned, he has to follow the same auditor procedure as in the case of the first issue of debentures, mentioned above

Mortgages and Charges. A company may have to borrow money from time to time to meet its financial needs Usually, it has to give some security for the loans taken by it and thus for this purpose it mortgages its assets According to Spicer and Pegler, "A mortgage is a transfer of an interest in property for the purpose of securing repayment of a loan with interest at a given rate" The expression 'charge' includes a mortgage as well, according to section 124 The company retains the possession of assets mortgaged until it makes default in the repayment of principal or interest on the same or commits any breach of other terms of the loans The charge may be floating or fixed A floating charge is not on any particular asset but on the whole assets of the company, and a fixed charge is on some particular fixed assets, say machinery

The auditor should note the express provisions of the Companies Act, 1956 with regard to the registration of Mortgages and Charges It is because any charge created by the company but not registered would be void

He should further note that according to section 125 of the Act, every charge created on or after the 1st day of April, 1914, by a company and being a charge shall, so far as any security on the company's property or undertaking is conferred thereby, void against the liquidator and any creditor of the company unless the prescribed particulars of the charge, together with the instrument, if any, by which the charge is created or evidenced, or a copy thereof verified in prescribed manner are filed with Registrar for registration within 21 days after the date of its creation But there is a proviso to this section which provides that the Registrar may extend the period of 21 days by seven days more if he finds sufficient cause for the same

The above mentioned provision is applicable to the following charges

(*a*) a charge for the purpose of securing any issue of debenture,
(*b*) a charge on uncalled share capital of the company,
(*c*) a charge on any immovable property, wherever situate, or any interest thereon,
(*d*) a charge, on any book debts of the company,
(*e*) a charge not being a pledge, on any movable property of the company,
(*f*) a floating charge on the undertaking or any property of the company including stock-in-trade,
(*g*) a charge on calls made but not paid,
(*h*) a charge on ship or any share in ship;
(*i*) a charge on goodwill, on a patent or a license under a copyright

He should note that under section 143, every company should keep at its registered office a Register of Charges and enter therein all charges specifically affecting property of the company, giving in each case—

(*i*) a short description of the property charged,
(*ii*) the amount of the charges, and
(*iii*) except in the case of securities to bearer, the names of the persons entitled to charge

According to section 132, the Registrar shall give a certificate under his hand of the registration of any charges registered Such certificate shall be conclusive evidence of the fact that all the requirements as to the registration have been duly complied with

Under section 138, the company shall give intimation to the Registrar of the payment of satisfaction, in full, of any charge relating to the company within 21 days from the date of such payment or satisfaction The Registrar will give notice to the holder of the charge and unless he represents against it, an entry of satisfaction will be made in the Register of Charges He will, then, furnish the company with a copy of the Memorandum of Satisfaction (section 140)

The auditor should examine and verify the charges with due care He should refer to the Memorandum and Articles of the company to find out whether the loans have been taken by the company within its borrowing powers The Director's Minute Book should be examined to see authorisation for raising of loans with the charges He should see that all the provisions of the Act given above with regard to the registration of charges have been duly observed He should inspect the Register of Charges and Certificate of Registration and copy of Memorandum of Satisfaction etc, in this connection He should ascertain that the secured loans have been separately shown in the Balance Sheet and also that the assets with the charge are specified as required under Part I of Schedule VI

OTHER TRANSACTIONS

Preliminary Expenses A company has to incur several expenses before it actually commences business Such expenses incurred in connection with the formation of the company are known as preliminary expenses These expenses are deferred revenue expenses and are shown as an asset in the Balance Sheet until they are written off However, it is advisable to write them off as soon as possible out of revenue profits or premium on issue of shares etc, if any It is necessary as they do not represent any asset

The preliminary expenses comprise of various expenses incurred by the promoters of the company A company comes into existence after all the legal formalities in this connection are complied with and it cannot commence business unless it obtains the certificate to commence the business The formation of company involves several expenditures. These preliminary expenses, for example are as follows .

(*i*) Legal expenses for drafting the Memorandum and Articles of Association, the Prospectus and the contracts with the vendors, Managing Agents etc, and the registration of the company.

(*ii*) Stamp duties on Memorandum and Articles and on preliminary contracts entered into by the company

(*iii*) Printing charges of various documents such as Memorandum, Articles of Association and Prospectus etc.

(*iv*) Cost of advertising the Prospectus

(*v*) Accountant's, valuer's, surveyor's fees for Report and Certificates etc.

(*vi*) Expenses incurred for preparing printing and stamping letters of allotment

(*vii*) Cost of preparing, printing and stamping of the debentures

(*viii*) Cost of company's seal and original Books of account

The auditor should vouch the preliminary expenses with the related vouchers, receipts, correspondence and contracts etc He must see that only proper expenses chargeable to it have been debited to it It is so because sometimes ordinary revenue expenses may be charged to the preliminary expenses with a view to show more profits in the very first year of the company's business

He should verify with reference to the contract entered with the vendors to ascertain whether they have agreed to bear the whole or a portion of preliminary expenses If it is so, he must see that the vendors have borne them according to the agreement, and the company is charged only by the amount to be payable by it If it is to be borne by the promoters, he should see that it has been done

The auditor must ascertain the estimated amount and the

limits of preliminary expenses mentioned in the Prospectus or Statement in Lieu of Prospectus or the Articles and he must see that the expenses have been incurred within limits If they have been incurred in excess of such limits he must see that they have been sanctioned by the shareholders

The auditor may offer suggestions to write them off soon Though it is not legally obligatory on the past of the company to do so, yet on financial grounds it is necessary that the company should write them off as soon as the profits are available for it

The auditor must see that expenses like brokerage, commission etc , have not been included in the preliminary expenses as they are to be shown separately

In case of the banking companies, the auditor should refer to section 15 of the Banking Companies Act, 1949 which prohibits the payment of dividends to its shareholders, until the preliminary expenses have been completely written off

He should see that the preliminary expenses have been shown in the Balance Sheet of the company under the head "Miscellaneous Expenditure" Of course, it would be shown with the balance of the expenses not written off upto that date

Commission on Shares and Debentures Section 76 of the Act permits a company to pay the commission to any person in consideration of (*i*) his subscribing or agreeing to subscribe for any shares in, or the debentures of, the company or (*ii*) his procuring or agreeing to procure subscription for any shares in or debentures of the company

But the company can do so only if the following conditions are fulfilled

(*i*) The payment of commission is authorised by the Articles

(*ii*) The commission paid or agreed to be paid does not exceed in the case of shares 5 per cent of the price at which the shares are issued or the amount of rate authorised by the Articles, whichever is less , and in the case of debentures 25 per cent of the price at which the debentures issued or the amount of rate authorised by the Articles whichever is less

(*iii*) The amount or the rate per cent of commission paid or agreed to be paid is disclosed in the Prospectus and in a Statement in lieu of Prospectus and in any other circular or notice inviting subscription

(*iv*) The number of shares or debentures which persons have agreed for a commission to subscribe absolutely or conditionally is disclosed in the manner aforesaid

(*v*) A copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the Prospectus or the Statement in lieu of Prospectus for registration

The above mentioned provisions are not applicable in case of the payment of brokerage on shares and debentures.

The auditor should distinguish between the underwriting commission, commission on placing shares and debentures, and brokerage on shares and debentures The underwriting commissions are payable to underwriters who enter into contract with the company to purchase all the remaining shares which would not be subscribed by the public If the public subscribe to all the shares offered, they will not have to purchase the shares at all but it will not deprive them of the commission They will get the underwriting commission as agreed But this condition is not applicable in case the commission is payable to a person for finding out an investor for subscribing to the shares of the company Such commission is known as the commission on placing shares Brokerage is different from these two as it is payable to the brokers or the bankers whose clients apply for shares on forms bearing their stamps or marks

The auditor should satisfy himself that the provisions of section 76 of the Act have been duly observed by the company He should verify that the rates at which the commission has been paid are well within the authorised limit placed under the given section or by the Articles of the company He should vouch such payment of commission very carefully with reference to agreement, receipts and other related vouchers He should ascertain that the underwriters have either paid the necessary application deposits, allotment and call money on the shares which they had to subscribe He should see whether it has been set off against the commission due to them. He should refer to the copy of the agreement entered into to verify the amount paid on the allotment of shares He should see that it has been properly disclosed in the Balance Sheet of the company under the head "Miscellaneous Expenses" In case the auditor finds that the underwriter's calls or payments on allotment are in arrear, he must disclose this fact in his report to the members of the company. It should be seen that the Annual Return must disclose the total amount of the sums, if any, paid by way of commission in respect of any shares or debentures up to that date

The auditor should examine the payment made by way of *brokerage* paid to the brokers with due care Section 76(3) contains express provisions with regard to the payment of brokerage on shares or debentures He must refer to the Articles of the company and find out the amount or rate per cent of the brokerage to be given He should also refer to the Director's Minute Book authorising its payment. He should vouch the payment with the receipts from the brokers. To see that only correct amount of brokerage has been paid to them, he should calculate it with the help of the prescribed rate per cent and the number of shares issued through them He should ascertain that the amount of brokerage not written off or adjusted has been shown in the Balance Sheet separately under the head "Miscellaneous Expenses"

Interest paid out of Capital during Construction Ordinarily

the interest is to be paid out of the revenue and not out of capital But the companies have been empowered to pay interest out of the capital also under section 208 of the Act It can be done by a company whose shares are issued for the purpose of raising money to defray the expenses of construction of any work or building or the provision of any plant which cannot be made profitable for long period

The following conditions, however, must be fulfilled by the company before it may pay interest out of capital:

(i) Its Articles authorise for such payments

(ii) Previous sanction of the Central Government has been taken The Central Government may undertake an enquiry at the expense of the company before giving such sanction The grant of such sanction by the Central Government shall be conclusive evidence that the shares of the company, in respect of which such sanction is given have been issued for the purpose of construction etc

(iii) The payment of interest shall be made only for such period as may be specified by the Central Government and that period shall in no case extend beyond the close of half year next after the half year during which the work or the building has been actually completed or the plant provided

(iv) The rate of interest shall in no case exceed 4% per annum or such other rate as the Central Government may, by notification in the Official Gazette, determine

(v) The payment of interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid

The above mentioned provision are not applicable in case any company to which the Indian Railways Companies Act, 1895 or the Indian Tramways Act, 1902 applies

The auditor must carefully examine that the conditions stated above for the payment of interest out of capital have been duly complied with He must see that previous sanction of the Central Government has already been obtained before such payment has been made And also, that it has been paid at the prescribed rate only He should see that it has been properly disclosed in the Balance Sheet under the head of "Miscellaneous Expenses" It may be debited to the assets account for which such interest has been paid since it is by way of capital expenditure and if it is so, it has not to be shown in the Balance Sheet separately

Profits or Losses Prior to Incorporation of the Company. A company may be formed to purchase an existing business at a certain agreed date But by that agreed date the new company might not have been incorporated. The new company would, however, be ntitled to the profits or losses prior to the date of the incorporation of the company It is to be noted that the Certificate of Incorporation

is issued by the Registrar of Companies after the prescribed formalities have been duly observed and such certificate alone is conclusive proof that the company has come into existence as a legal entity Before a company gets such certificate, it will have no legal entity at all A new company, for example, might have purchased the existing business on 31st December, 1964 but the Certificate of Incorporation is issued to it on 1st April, 1965 Under such circumstances, the new company may earn profits or incur losses from 31st December, 1964 to 1st April, 1965 since the business was running during this period Such profits or losses would not be ordinarily available to the shareholders as dividends since they do not belong to them as the company did not exist legally till then A company cannot be supposed to earn anything before it legally comes into existence Also, because the purchase price includes the estimated amount of profits that would accrue to the new company and if the dividend is paid out of such profits for which shareholders have already paid, that would amount to return of part of the capital contributed by the shareholders It is neither legal nor advisable The Companies Act, 1956 is, however, silent on this issue

Usually, the accounts are not balanced and Final Accounts are not prepared on the date of incorporation of the company but are prepared at the end of the year or so They may be prepared on 31st December and not on 1st April as per example above If it is so, the difficulty arises as regards the apportionment of profit of the year between the two periods—prior to incorporation of the company and after that period.

There is a difference of opinion whether the apportionment of profit or loss between the two periods should be made from the date of incorporation of the company or the date of obtaining the Certificate to commence business The controversy relates to public company only as a private company can start business after obtaining the Certificate of Incorporation of the company and need not wait for the Certificate to commence business The apportionment of profit of loss should be made from the date of the incorporation of the company and not from the date from which the company is entitled to commence business It is appropriate and is more commonly adopted because "since once that Certificate (entitling to commence business) has been issued, the company's power of legally carrying on business relates back to the date of incorporation "

The apportionment is commonly made on the basis of time or turnover or both. The turnover basis of apportionment of profit or loss is preferred An accurate and reliable method is to apportion the gross profits and the expenses which vary with the turnover, on the basis of the respective turnover of the two periods But all other expenses should be apportioned on the basis of time Certain adjustements however, in the incomes and expenditures between the two periods should be made to arrive at the correct amount of profit for the two periods For example, exceptional items like directors' fees, interest on debentures, expenses incidental to the formation of the

company, or expenses incurred in connection with the previous owner's management etc , should be properly adjusted to the profits or losses by adding to or deducting from them as the case may be.

The auditor should examine the basis of apportionment of the profits or losses for the two periods and see that they have been correctly arrived at and equitably distributed between the two periods If he finds that there is profit prior to incorporation of the company he should see that it has been transferred to the Capital Reserve or utilised in writing off the amount of goodwill or in adjusting the amount of fixed assets, if necessary, or in payment of the interest on the purchase price to the vendors, if so agreed On the other hand, if he finds that there is loss prior to the incorporation of the company, he should see that such losses have been debited to the Goodwill or Capital Reserve or have been carried forward to be written off later out of the capital profits of the company He should, however, make sure that the profit prior to the incorporation of the company are not distributed to the shareholders as dividends.

QUESTIONS

1 What procedure would you, as an auditor, follow to audit the transactions related to issue of debentures ?

2 How would you audit redemption of debentures and their reissue ?

3 How would you audit the following

(a) Profits prior to incorporation of Co

(b) Commission on issue of shares.

(c) Preliminary expenses

4 How would you audit mortgages and changes of assets in case of a company ?

5 Can a company pays, interest out of capital ? Explain auditor's duty

18

Statutory Report and Audit

STATUTORY REPORT

The auditor should be familiar with the provisions of section 165 of the Companies Act, 1956 which deals with the Statutory Meeting, Statutory Report and audit thereof He is mainly concerned with the audit of Statutory Report.

The Act provides that every company limited by shares and every company limited by guarantee and having a share capital, shall hold a general meeting of the members of the company However, a private company is not required to hold a statutory meeting or prepare a statutory report Such meeting shall be held within a period of not less than one month and not more than six months from the date the company is entitled to commence business The meeting is called the "Statutory Meeting"

The Board of directors shall send a report known as "Statutory Report" to every member of the company It must be circulated at least 21 days before the date of the meeting A private company is not required to forward the Statutory Report to its members or file it with the Registrar.

There is an express provision in section 165 with regard to the particulars to be mentioned in the Statutory Report. These are —

(*i*) Total number of shares allotted, distinguishing shares allotted as fully or partly paid-up otherwise than in cash In the case of shares partly paid-up, stating the extent to which they are so paid-up

(*ii*) The consideration for which the shares have been allotted

(*iii*) Total amount of cash received by the company in respect of all the shares allotted

(*iv*) An abstract of the receipts and payments of the company upto date within seven days of the date of the Report and particular concerning the balance in hand

(*v*) An account for estimate of the preliminary expenses of the company showing separately any commission or discount paid or to be paid on the issue or sale of shares and debentures

(vi) Names, addresses and occupation of the directors, auditors, managing agents or secretaries and treasurers, manager and secretary of the company and changes therein, if any, since the date of the incorporation of the company

(vii) Particulars of any contracts and the proposed modifications of such contracts, if any modification has to be made, which are to be submitted to the meeting for its approval.

(viii) The extent to which any underwriting contract has not been carried out and the reasons therefor

(ix) Arrears due on calls from every director, managing agent, secretaries and treasurers, and the manager

(x) Particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares or debentures to any director, managing agent, secretaries and treasurers or manager

The Statutory Report with the above particulars in a form given below—Form 22 of the Companies (Central Government's) General Rules and Forms, 1956—must be certified as correct by not less than two directors of the company, one of whom shall be a managing director, where there is one Its copy must be filed with the Registrar for registration forthwith after copies thereof have been sent to the members of the company

No of company. Form No 22
Filing Fee Rs 5

THE COMPANIES ACT, 1956
Statutory Report
Pursuant to Section 165

Name of Company
Statutory Report of the Limited,
certified and filed pursuant to section 165 (5)
Presented by ... ...
. ...

The Board of Directors submits the statutory report to the members in pursuance of section 165

1 *Shares allotted and cash received upon* ... (a)

No of shares	Nominal value of each share	Cash received upto (a)

(a) Allotted subject to payment thereof in cash

(i) Equity

(ii) Redeemable Preference Shares

(iii) Preference shares other than Redeemable Preference Shares

(b) Allotted as fully paid up otherwise than in cash and the consideration for which they have been allotted

(i) Equity

(ii) Redeemable Preference Shares

(iii) Preference Shares other than Redeemable Preference Shares

(c) Allotted as partly paid up to the extent of Rs . . per share, and the consideration for which they have been so allotted

(i) Equity

(ii) Redeemable Preference Shares

(iii) Preference Shares other than Redeemable Preference Shares

(d) Allotted at a discount of Rs . ... per share

(i) Equity

(ii) Redeemable Preference Shares

(iii) Preference Shares other than Redeemable Preference Shares

2 *Abstract of receipts and payments upto (a)*—

Receipts	Rs	Payments	Rs
Shares		*Preliminary expenses*	
Equity		Commission on issue or sale of shares	
Redeemable Preference Shares		Discount on issue shares	
Preference Shares other than Redeemable Preference shares		*Capital Expenditure*	
Advance payment for shares		Land	
Debentures		Building	
Loans		Plant	
Deposits		Machinery	
Other sources (to be specified)		*Other Items to be specified*	
		Balances	
		In Hand	
		At Banks .	
		At Post Office Savings Bank	
Total		Total	

(a) The date should be a date within 7 days of the Report

3 *Preliminary expenses as estimated in the Prospectus* or Statement in lieu of Prospectus*

	Preliminary expenses actually incurred upto aforesaid date Rs	Preliminary expenses estimated to be incurred after the aforesaid date Rs
Low Charges		
Other charges in connection with the preparation of the Memorandum and Articles of Association		
Printing expenses		
Registration charges		
Advertisement charges		
Commission on issue or sale of shares		
Discount on issue or sale of shares		
Other initial Expenses (to be specified as far as possible)		
Total Rs.		

*Strike out the portion which does not apply

4 *Names, addresses and occupation of the company's Directors, auditors, Manager and Secretary*

Name (s)	Address (es)	Occupation (s)	Particular of change (s) if any, in entries in columns (1) (2) and (3) since the date of incorporation	Date of the change
1	2	3	4	5
A Directors				
B Auditors				
C Manager				
D Secretary				

These particulars must include dates of changes

5 *Particulars of any contract which is to be submitted to the statutory meeting for approval*

(If any modification or proposed modification of a contract and particulars of modification or proposed modification should be given)

6 *Underwriting Contracts*

Brief description of each contract.

If contract and carried out fully, extent to which it has not been carried out and reasons thereby

7 *The arrears, if any, due on calls from Directors, and Manager.*

Names	Amount due.
Directors	
Names	Amount due.
Manager	

8 Particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares to any director or manager

Name	Commission or Brokerage paid or to be paid
Directors	On shares On Debentures
Directors	
Manager	

Dated this day of 19

We hereby certify that the above report is correct Signatures of two or more directors *

We hereby certify as correct so much of the report as relates to shares alloted by the company and to the cash received in respect of such shares and to the receipts and payments

Auditors

Dated this day of 19

STATUTORY AUDIT

The audit of Statutory Report under section 165 is commonly known as Statutory Audit The auditor of a company has to certify the Statutory Report as correct in certain specified respects after it has been certified by the directors etc , but prior to holding of Statutory Meeting by the company Its audit and issue of certificate on the Report are limited to the following items of the Report only—

(*i*) Shares allotted by the company ,

(*ii*) Cash received in respect of such shares , and

(*iii*) Receipts and payments of the company.

*Where there is a managing director, he shall be one of the signatories

To *certify* the above items of the Report as correct, the auditor will have to carry on exhaustive checking of the share capital transactions An enquiry should be made about the system of internal check in use with regard to the receipts, payments and other transactions and recording thereof. He will have to vouch in detail the Cash Book for entries made therein with regard to the receipts and payments, which may be on capital as well as revenue account He must examine and verify the balance in hand.

So far as the *verification of shares allotted* by the company and cash received in respect thereof is concerned, the auditor should see that all the provisions of law in this connection have been duly complied with He should refer to the Memorandum and Articles of Association of the company and the Prospectus issued etc, and see that various terms provided therein have been duly followed He should refer to the Directors Minute Book for the allotment of shares For this he should also examine the Cash Book and Register of Members etc However, he should check the share capital transaction in detail on the lines given earlier

For the *verifications of receipts and payments* of the company, he should see that all the receipts and payments are within the scope of the company and have been duly and properly authorised. They should also be supported by adequate vouchers He should proceed as follows

(*i*) Vouch carefully the cash received on account of shares and debentures as appearing in the Ledger with the Application Book, Allotment Book and Register of Members, Debentures, etc ,

(*ii*) Vouch in detail the commission and brokerage paid for the issue of shares or debentures ,

(*iii*) Vouch payments to vendors with reference to the contracts entered into and the Directors Minute Book ,

(*iv*) Vouch the preliminary expenses thoroughly and check that the amounts recoverable from the promoters or vendors on account of preliminary expenditures have been duly collected and that they do not exceed the limit laid down in the Prospectus and the Articles ;

(*v*) Vouch the purchase of fixed assets, if any, with the help of the Directors Minute Book and the contract with supplies and the receipts given by them ,

(*vi*) Vouch all the receipts and payments of the company in detail upto a date not more than seven days before the date of the Report ,

(*vii*) Examine and compare the records in Bank Pass Book and reconcile them with the Cash Book Also obtain a certificate from the bankers about the balance in the bank Verify carefully the balance in hand also ,

(*viii*) See that all the receipts and payments of the company have been shown in the Report under appropriate heads

Auditor's certificate On being satisfied about the correctness of the above mentioned particulars of the Statutory Report, he should furnish a certificate to the directors of the company as follows .

> "We hereby certify that the Statutory Report so far as it relates to the shares allotted by the company and to the cash received in respect of such shares and to the receipts and payments of the company is correct "
>
> Auditors

QUESTIONS

1 What is a Statutory Report ? What particulars should be mentioned in it ?

2 What is a Statutory Report ? Discuss auditor's duty in this connection ?

3 You have been appointed the first auditor of a new company How would you undertake the Statutory audit ?

4 How would you undertake the audit of Statutory Report of a company ?

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Managerial Personnel

The managerial personnel of the company are those persons who are entrusted with the control and management of the whole or substantially the whole of a company's affairs and include the following .

(*i*) Directors (including whole-time Directors)

(*ii*) Managing Director

(*iii*) Manager

Every company must have the directors and may also have a managing director or Manager The Companies Act, 1956 has placed various restrictions or limitations on the powers or rights of these managerial personnel with a view to bring healthy development of the companies in the best interest of the large number of shareholders

An auditor should be familiar with the relevant provisions of the Companies Act relating to their appointment, terms of office , powers, duties, remuneration etc He should ensure that they have been duly observed by the management, specially with regard to the accounts of the company These provisions are given below under appropriate heads The provisions relating to remuneration are studied in the next chapter

THE DIRECTORS

The Companies Act, 1956 provides that every public company, or a private company which is subsidiary of a public company, must have at least three directors and a private company must have at least two directors But only an individual can become a director and a body corporate, association or firm cannot become a director of a company If a public company wants to appoint a Managing Director or a whole time Director, it will have to obtain the previous sanction of the Central Government Under section 275, no person can be director, at the same time, of more than twenty companies

Under section 270, every director, who is required by the Articles of the company to hold a specified share qualification, will have to obtain his qualification shares within two months after his appointment as director Any provision of the Articles will be void if it requires a person to hold qualification shares before his appointment or to obtain them after two months of his appointment The

nominal value of the qualification shares shall not exceed five thousand rupees, or the nominal value of one share where it exceeds five thousand rupees Every director, not being a technical director or a director appointed by the Central or State Government, shall file with the Registrar a declaration specifying the qualification shares held by him within two months after his appointment

Powers of Board of Directors The directors of a company act as its agents as well as trustees They can do anything and exercise all such powers which a company can do, unless restricted by the Articles and the Memorandum or the Companies Act itself The auditor should very carefully examine that the provisions of the Articles and Memorandum placing restrictions on their powers have been duly observed He should also see that the following provisions of the Act, placing restrictions on their powers, have not been violated

Under section 292, the following powers of the Board shall be exercised only at a meeting of the Board

(*i*) To make calls
(*ii*) To issue debentures
(*iii*) To borrow money.
(*iv*) To invest funds of the company
(*v*) To advance loans

The Board may, however, delegate the powers mentioned under (*iii*), (*iv*) and (*v*) But it will have specify the limits and spheres in which such powers may be exercised

Section 293 lays down that the Board of Directors of a public company, or of a private company which is a subsidiary of a public company, shall not exercise the following powers without the consent of such company in its general meeting

(*a*) To sell, lease or otherwise dispose of the undertaking of the company
(*b*) To remit or give time for repayment of a debt due by a director except in the case of renewal or continuance of an advance made by a banking company to its directors in the ordinary course of business
(*c*) To invest, otherwise than in trust securities, the amount of compensation received by the company in respect of the compulsory acquisition, after the commencement of the Act, of any such undertaking
(*d*) To borrow moneys, where the moneys to be borrowed, together with the moneys already borrowed by the company (apart from the temporary loans obtained from the company's bankers in the ordinary course of business) exceed the aggregate of the paid up capital and free reserve
(*e*) To contribute to charities etc. not related to the business or welfare of its employees exceeding Rs. 25,000 or 5% of

average net profits during the three financial years immediately preceding, whichever is greater

Under section 294(2), after the commencement of the Companies (Amendment) Act, 1960 (i e 28th December, 1960) the Board of directors of a company shall not appoint a sole selling agent for any area except subject to the condition that the appointment shall cease to be valid, unless approved by the company in the first general meeting held after the date on which the appointment is made

The Board of directors have been given power under section 298 to carry on, or arrange for the carrying on, of the affairs of the company when the managing agent or secretaries and treasurers are deemed to have vacated or to have been suspended from office The Board will be entitled to act as such until the managing agent or secretaries and treasurers again become entitled to act as such, or until the company in general meeting resolves otherwise

Loans to Directors Section 295 of the Act has placed several restrictions for advancing loans to the directors No company shall, without obtaining previous approval of the Central Government, make any loan to, or give any guarantee or provide any security in connection with a loan made by any other person to, or to any other person by—

(*a*) any director of the lending company of its holding company or any partner or relative of any such director

(*b*) any firm in which any such director or relative is a partner,

(*c*) any private company of which any such director is a director or member ,

(*d*) any body corporate, at a general meeting of which not less than 25% of the total voting power may be exercised or controlled by any such director, or by two or more such directors together , or

(*e*) any body corporate, whose Board of directors, managing director, managing agent, secretaries and treasurers or manager is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors of the lending company

The above provisions shall not apply to any loans made, guarantee given or security provided by—

(*a*) a private company unless it is subsidiary of a public company ,

(*b*) a banking company ,

(*c*) a holding company to its subsidiary ,

(*d*) a company which is the managing agent or secretaries and treasurers of another company to that company.

According to section 296 as amended all the above provisions of section 295 shall apply to any transaction represented by a book

debt which was from its inception in the nature of a loan or an advance

Board's Sanction for Contracts Section 297 provides that the consent of the Board of directors of a company must be taken, if (*a*) a director of the company or his relative, (*b*) a firm in which such director or relative is a partner, (*c*) any other partner in such a firm or a private company of which the director is a member or director—wish to enter into contract with the company for the sale, purchase or supply of any goods, material or services or for underwriting of its shares and debentures The Board shall have to passa, resolution at a meeting to give its consent The consent, however must be accorded before the contract is entered into, or within three months of the date on which it was entered into

This provision is, however, not applicable in case any contract for sale, purchase etc in which such company or director etc regularly do business, provided the value or cost thereof does not exceed Rs 5,000 in the aggregate in any year comprised in the period of the contract

Under Companies (Amendment) Act, 1974, it has been provided that in case of a company having paid-up share capital of not less than Rs 1 crore, no such contract share be entered into except with the previous approval of central government

Disclosure of Interest Every director of a company who is, directly or indirectly, interested in a contract or arrangement, proposed or entered into by the company must disclose the nature of his interest at a meeting of the Board of directors The director will have to give general notice to the Board to the effect that he is director or a member of any company or firm, and is to be regarded as interested in any contract with such company or firm Such notice expires at the end of the financal year, hence that should be renewed every year (section 299)

A Register of contracts, companies and firms in which directors are interested has to be maintained by the company with proper details (section 301)

Under section 302, a company shall, within twenty-one days from the date entering into the contract or of the varying of the contract, send to every member of the company an abstract of the terms of the contract or variation together with a memorandum clearly specifying the nature of the concern or interest of the director in such a contract or variation The members have to be informed where a company—

(*a*) enters into a contract for the appointment of a manager of the company in which contract any director the company is, directly or indirectly, concerned or interested, or

(*b*) varies any such contract already in existence and in which a director is concerned or interested as aforesaid.

Holding Office of Profit. An auditor of a company should note the restrictions placed under section 314 upon a director from holding office of profit Under this section, certain persons cannot hold any office of profit carrying a total remuneration of Rs 5000 or more under a company or any subsidiary thereof unless the remuneration received from such subsidiary in respect of such place of profit is paid over to the company or its holding company For holding such place of profit, the following persons will have to obtain the consent of the company by special resolution

(*a*) a director of the company,

(*b*) a partner or relative of such director,

(*c*) a firm in which such a director or relative is a partner,

(*d*) a private company of which such a director is a director or member,

(*e*) any director, or manager of such a private company.

Here the office or place of profit does not include the office of managing director, manager or technical advisor, banker or trustee for the holders of the debentures of the company

But where a relative of a director or a firm in which such a relative is a partner, is appointed to an office or place of profit without the knowledge of the director, the consent of the company must be obtained either in the general meeting held for the first time after holding of such office or place of profit in the company within 3 months from the date of the appointment When the appointment of a relative of the director has taken place without the knowledge of the director, such consent can be obtained in the general meeting ot the company or within 3 months, whichever is earlier.

Compensation for Loss of Office Under section 318, compensation for loss of office is permissible only to (*a*) managing director, (*b*) whole time director, and (*c*) directors who are managers Such compensation shall not exceed the remuneration which he would have earned if he had been in office for the unexpired residue of his term or for three years, whichever is shorter It shall be calculated on the basis of average remuneration actually earned by him during the 3 years immediately preceding or for such shorter period for which he held office

No compensation, however, shall be made to a director in the following cases

(*a*) where he resigns in view of the reconstruction of the company or its amalgamation and is appointed as the managing director, manager or other officer of the reconstructed or amalgamated company,

(*b*) where he resigns otherwise than on the reconstruction of the company or its amalgamation ,

(*c*) where the office of the director is vacated by virtue of section 203 (dealing with power to restrain fraudulent persons from

managing companies), or section 283(1) (dealing with vacation of office),

(*d*) where the company is being wound up, whether by or subject to the supervision of the Court or voluntarily, provided the winding up was to the negligence or default of the director,

(*e*) where he has been guilty of fraud, breach of trust or of gross negligence or mismanagement of the company, and

(*f*) where he has instigated the termination of his office

Report by the Board The Board of directors has to submit a report which has to be attached to every Balance Sheet laid before a company in its general meeting (section 217) Such report will be in respect to—

(*a*) the state of company's affairs,

(*b*) the amounts, if any, which it proposes to carry to any reserve in such Balance Sheet,

(*c*) the amount, if any, which it recommends should be paid, by way of dividend, and

(*d*) material changes and commitments, if any affecting its financial position which have occurred between the end of the financial year to which the Balance Sheet relates and date of the report

The report will also mention (so far as is material for the appreciation of the state of company's affairs by its members and will not in the Board's opinion be harmful to the business of the company or of any of the subsidiaries) about any changes which have occurred during the financial year—

(*a*) in the nature of its business,

(*b*) in its subsidiaries or in the nature of the business carried on by them, and

(*c*) in the classes of business in which it has an interest

Under Companies (Amendment) Act, 1974, it has also been provided that the Board's report shall also include a statement showing the name of every employee of the company who—

(*i*) if employed throughout the financial year, was in receipt of remuneration for that year, which in the aggregate, was not less than thirty-six thousand rupees,

(*ii*) if employed for a part of the financial year, was in receipt of remuneration for any part of that year, at a rate which, in the aggregate, was not less than three thousand rupees per month

The statement, as mentioned above, shall also indicate (*i*) whether any such employee is a relative of any director or manager of the company and if so, the name of such director, and (*ii*) such other particulars as may be prescribed

The Board's report should also contain in an addendum the fullest informations and explanations with regard to every reservation qualification or adverse remarks contained in the auditors' report

It should be signed by the Chairman if he is authorised to do so by the Board If not so authorised, it will be signed by such number of directors as are required to sign the Balance Sheet and the Profit and Loss Account by virtue of Section 215 (1) and (2)

MANAGING DIRECTOR

The company may appoint one of its directors as the managing director He is entrusted with the powers of management of the company but not necessarily the whole or substantially the whole management of its affairs

He may be appointed in its general meeting or by the Board of directors, provided the Articles of the company so permit But his appointment would be void if not approved by the Central Government (Section 296)

A managing director cannot be appointed for more than five years at a time He may, however, be reappointed for further five years within two years of the date of existing term (Section 317) This restriction is not applicable to a private company which is not a subsidiary of a public company

A person cannot be the managing director of two companies at a time However, a public company or a private company which is subsidiary of a public company may appoint or employ a person as its managing director if he is the managing director of one, and of not more than one, other company Thus an individual can be managing director of only two companies at a time (Section 316) The compensation for loss of office is payable to him also under section 318 mentioned earlier

MANAGER

The term manager means "an individual (not being the agent), who, subject to the superintendence, control and direction of the Board of directors, has the management of the whole or substantially the whole, of the affairs of a company, and includes a director or any other persons occupying the position of a manager, by whatsoever name called, and whether under a contract of service or not" [Section 2 (24)]

Under the Act, the following restrictions have been placed on the appointment of managers

(*i*) A firm or a body corporate cannot be appointed a manager of a company , only an individual can be so appointed (Section 384)

(*ii*) The following persons cannot be appointed as manager of a company

(*a*) an undischarged insolvent or one who has, any time within the preceding five years, been adjudged as an insolvent , or

(*b*) a person who suspends or suspended, within the preceding five years, payment to his creditors or makes a composition with them, or

(*c*) a person who has been convicted by a Court in India of an offence involving moral turpitude.

The Central Government may, however, remove the above disqualifications through notification in the Official Gazette

(*iii*) In general, a person may be appointed the manager of only one company at a time He may, however, hold managership of two companies only if so approved by the Board

(*iv*) He cannot be appointed as manager of a company for more than five years at a time He may be reappointed for five years again, within two years of the existing term (section 317)

QUESTIONS

1 Explain the provisions of Companies Act, 1956, which restrict the powers of Boards of Directors Discuss auditor's duty in this connection

2. Discuss the powers of Board of Directors of a company

3. Explain the restrictions imposed upon Managing Director and Manager of a company Discuss auditor's duty in this connection.

4. What is a Director's Report? Explain its content fully

Managerial Remuneration

The Companies Act, 1956 has for the first time limited the remuneration of the managerial personnel These limits may be studied under the following two heads

(A) Overall limit to the managerial remuneration , and

(B) Specific limits, i e , limits over remuneration to be paid to each managerial personnel

(A) OVERALL LIMIT

The overall maximum managerial remuneration has been fixed at 11% of the net profit of a public company in respect of any financial year (section 198) For the purpose of this and other related sections, however, "remuneration" shall include—

(*a*) any expenditure incurred by the company in providing any rent free accommodation, or any other benefits or amenity in respect of accommodation free of charge, to any of the managerial personnel ,

(*b*) any expenditure incurred by the company in providing any other benefit or amenity free of charge or at concessional rate to them ,

(*c*) any expenditure incurred by the company to effect any obligation or service which, but for such expenditure by the company, would have been incurred by any of these persons , and

(*d*) any expenditure incurred by the company to effect any insurance on the life of, or to provide any pension, annuity, or gratuity for, any of the managerial personnel, or his spouse or child

It shall, however, *exclude* any fee payable to the directors for attending the meetings of the Board

The payment of monthly remuneration may be made to the managing or wholetime director of a company according to section 309, but within the over-all limits Similar payment may be made to a manager of the company also according to section 387.

The calculation of the net profits shall be made in the manner specified in sections 349, 350 and 351, as given below It should, however, be noted that while making such calculations, the remuneration of director shall not be deducted from the gross profits

In this connection the auditor should carefully note that in computing the net profits of a company in any financial year—

1 Credit shall be given for

(*a*) bounties and subsidies received from any government or any public authority constituted or authorised by any government, unless the Central Government otherwise directs

(*b*) so much of the excess of as is not higher than the difference between the original cost of that fixed asset and its written down value, if the amount for which any fixed asset is sold exceeds its written down value

2 No credit shall be given for

(*a*) profits, by way of premium, on shares or debentures which are issued or sold by the company ,

(*b*) profits on sales of forfeited shares ,

(*c*) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof ,

(*d*) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, wholly, or partly, of buying and selling any such property or assets

3 The following sums *shall be deducted*

(*a*) all the usual working charges ,

(*b*) directors' remuneration ,

(*c*) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis ,

(*d*) any tax notified by the Central Government as being in the nature of a tax on excess of abnormal profits ,

(*e*) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf ,

(*f*) interest on debentures issued by the company ,

(*g*) interest on mortgage executed by the company and on loans and advances secured by a charge on its fixed or floating assets ,

(*h*) interest on unsecured loans and advances ,

(*i*) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature ,

(*j*) outgoings inclusive of contributions made to charitable and other funds not directly related to the business of the company or the welfare of its employees,

(*k*) depreciation amount calculated with reference to the written down book value of assets at specified rates and rules,

(*l*) the excess of expenditure over income, which had arisen in computing the net profits in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which net profits have to be ascertained,

(*m*) any compensation or damages to be paid by virtue of any legal liability, including a liability arising from a breach of contract,

(*n*) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (*m*); and

(*o*) debts considered bad and written off or adjusted during the year of account

4 The following sums shall *not be deducted*

(*a*) remuneration payable to the managing agent,

(*b*) income-tax and super-tax payable under the Indian Income Tax Act, 1922, or any other tax on the income of the company with the exception of excess profits tax and any special tax on business profits by the Central Government,

(*c*) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of any legal liability including a liability arising from breach of contract, and

(*d*) loss of capital nature including the loss on sale of the undertaking of any of the undertakings of the company or of any part thereof not including any excess of written down value of such assets, over its sale proceeds or its scrap value which is sold, discarded, demolished or destroyed

5 Where there is an arrangement between two or more companies to share their profits, and not less than two of those companies have the same managing agent, any profits, paid in pursuance of the arrangement by any of the companies having that managing agent to any other or others of them shall—

(*a*) be excluded from the net profits of the company making such payments,

(*b*) be included in the net profits of the company receiving such payment, or where more than one company receives

such payment, be included in the net profits of each of the receiving companies, to the extent of the payment received by it.

Minimum Remuneration If in any year, there are no profits or the profits are inadequate, the company may pay to any director or directors (including any managing or whole-time director), its managing agent, secretaries and treasurers, or manager or if there are two or more of them holding office in the company, to all of them together, by way of minimum remuneration a sum not exceeding Rs 50,000 per annum [section 198 (4)] But, for this purpose, the approval of Central Government must be taken

This sum by way of minimum remuneration may, however, be increased by the Central Government, if it is satisfied that for the efficient conduct of the business the minimum remuneration would not be sufficient.

(B) SPECIFIC LIMITS

Besides, the limits placed with regard to the overall managerial remuneration, various restrictions have also been put over the remuneration of each managerial personnel They may be presented in a chart as follows.

Overall Maximum Managerial Remuneration
(11% of net profits)

Managing Director, whole-time Director—5% if one, 10% if more than one

Any other Director—1% if there is also a Managing or whole-time Director, and Manager 3%, if not

Manager 5%

Directors and Managing Director The remuneration of a director is payable in accordance with the provisions of the Articles of the company, or by a resolution, or if the Articles so require, by a special resolution passed by the company in its general meeting

A director who is either a whole-time director or a managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company, or partly by one way and partly by the other (section 309) But except with the approval of the Central Government, such remuneration shall not exceed 5% of the net profits of the company for one such director, and if there is more than one such director, 10% for all of them together.

In case of the directors, who are neither whole-time nor managing director and whose remuneration does not include a

monthly payment, the company may pay commission not exceeding (i) 1% of the net profits, if the company has a managing or whole time director, or a manager, and (ii) 3% of the net profits in any other case A special resolution has to be passed authorising such payment, but that will be valid for five years only But this limit about the payment of the commission may be extended by the company in its general meeting provided the approval of the Central Government has been taken for it

It should be noted that after the amendment of the Act in 1960, payment to the directors for attending the Board's meetings cannot be made on monthly basis He can be paid on the basis of a fee paid for each meeting The directors are not entitled to receive the travelling expenses incurred by them for attending the Board's meetings unless the Articles or a resolution at a general meeting specifically allow them

A whole-time or managing director, who is in receipt of any commission from the company cannot at the same time receive any commission from any subsidiary of the company.

Through the amendment of the Act, it has also been provided that if any director receives, directly or indirectly, by way of remuneration any such sum in excess of the limits mentioned above, or without the prior sanction of the Central Government, wherever it is required he shall refund such sums to the company and until such sum is refunded hold it in trust for the company

The company cannot waive its right to recover any sum refundable to it from the directors if they have received remuneration in excess of the prescribed limits mentioned above

The calculation of the net profits for the purpose of computing the remuneration for the directors has to be made in accordance with the provisions of sections 349, 350 and 351 as mentioned earlier But there is an exception that the remuneration of the directors shall not be deducted from the gross profits

Increase in Recommendation of all Directors Any increase in the remuneration of a director, including the managing or whole-time director of a public company or a private company which is a subsidiary or a public company, requires the approval of the Central Government If there is any condition in the agreement which purports to increase the remuneration of a director that would require the sanction of the Central Government (section 310) Such approval shall not be required if fee for attending meetings of the Board is increased not exceeding two hundred and fifty rupees

Increase in the Remuneration of Managing Director or Whole-time Director If the terms of any appointment or reappointment of a managing or whole-time director after the commencement of the Companies Act, 1956, purport to increase the remuneration in excess of that received prior to the Act, such appointment or reappointment would require the sanction of the Central Government (section 311).

Manager The manager of a company may receive remuneration by way of a monthly salary or by way of specified percentage of the net profits of the company calculated in specified manner But it has been limited to 5% of the net profits This is, however, subject to the overall limits imposed on managerial remuneration mentioned earlier The amendment of the Act provides that the remuneration to a manager of a company may be paid in excess of 5% of the net profits of the company only after getting approval of the Central Government (section 387)

AUDITOR'S DUTIES

A company auditor has to perform a very important duty while auditing the remuneration paid to various managerial personnel He has not only to exercise caution, vigilance and apply his tools of auditing but also to keep in mind the various statutory provisions which have already been mentioned earlier It will be his duty to ascertain that the various provisions of the Act have been duly observed by the company while making payment to them He will have to take extra precaution in finding out that the net profits of the company have been calculated in accordance with the provisions of the Act and the remunerations given to them have not been paid in excess of the limits placed Nothing more should be paid to them what is due to them He should satisfy himself that there is proper disclosure of the managerial remuneration in the books of account of the company He should see that suitable notes have been given with regard to the perquisites to the managerial personnel converted into money values He should ascertain that prior permission or sanction of the Central Government has already been taken wherever it is required.

We give below the steps to be taken by him in auditing the remuneration paid to various managerial personnel of the company

Directors (*i*) The auditor should refer to the Register of Directors and managers to find out who the directors are He should examine carefully the Articles of the company for their remuneration For the remuneration not specified in the Articles, he should examine the resolutions passed by the company in its general meeting He should refer to agreements, if any, entered into by the company with the directors He should ascertain that the approval from the Central Government has already been taken, wherever necessary He should verify that the directors do not continue after the term of appointment is over

(*ii*) He should check the calculation of the remuneration payable to them and should specially see that the net profits have been computed in specified manner

(*iii*) For the payment of directors' fees should refer to the Articles of the company or the resolution passed sanctioning such payment He should then vouch such payment with reference to the receipts from the directors or returned endorsed cheques in the

absence of any receipts If there is any doubt as to the basis of the calculation of the fees, the matter should be referred to the share-holders in the general meeting of the company In case the directors forego the claim to the fees, the auditor should see the Minute Book to find out whether the directors have signed it or not

(*iv*) For travelling expenses paid to them, he should see the Articles and the resolution passed in the general meeting of the company entitling them for such expenses He should further satisfy himself that such expenditures were incurred in the interest of the company' business He should then vouch them with the bills and receipts If the travel is by air, the counterfoil of the air ticket should be examined He should see that it has been properly authorised

(*v*) Remuneration, paid or some special work should be verified by reference to the special resolution passed by the company

(*vi*) He must see that the remuneration paid on them are within the specified statutory limits If there is any increase in the remuneration, he should find out that it has been approved by the Central Government

(*vii*) Any remuneration which remains unpaid to the date of the Balance Sheet should be properly provided for as outstanding liabilities

(*viii*) He should ascertain that the provisions of the Act requiring compulsory disclosure in the Profit and Loss Account of the total remuneration paid to the directors have been duly complied with

Manager Audit of remunerations paid to managers should be carefully carried on by the auditor While doing so, he should keep in mind the relevant statutory provisions which have already been mentioned earlier He should follow the similar procedure as mentioned above in connection with the audit of remunerations of directors

QUESTIONS

1 Explain the auditor's duties regarding the remuneration of managerial personnels of a company

2 Explain the provisions of Companies Act, 1956 regarding managerial remuneration Discuss auditor's duty in this connection.

3 Discuss auditor's duty regarding remuneration of directors of a company

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Company Branch and Annual Account

BRANCH OFFICE ACCOUNTS

A company may have its branch offices carrying on more or less similar activities as carried on by the Head Office Every branch of a company, whether it is in India or abroad, has to maintain proper books of account related to its transactions It has also to send to its Head Office the summarised return at intervals of not more than three months Unless exempted by the Central Government, every company must get the accounts of its branch offices duly audited

Where a company has a branch office, the accounts of that office shall be audited by (*i*) the company's auditor appointed under section 224, or (*ii*) by a person qualified for appointment as auditor of the company under section 226, or (*iii*) where the branch office is situated outside India either (*a*) by the company's auditor, or (*b*) by a person qualified as aforesaid, or (*c*) by an accountant duly qualified to act as auditor of the accounts of the branch office in accordance with the laws of that country [section 228 (*i*)]

The company can get accounts of its branch office audited by its own auditor But if it decides in its general meeting to have the accounts of a branch office audited not by the company's auditor, it may—

(*i*) appoint a person qualified for appointment as auditor of the company under section 226 , or

(*ii*) authorise the Board of directors to appoint such a person in consultation with the company's auditor , or

(*iii*) where the branch office is situated outside India, appoint a person who is either qualified as aforesaid or an accountant duly qualified to act as an auditor or the accounts of the branch office in accordance with the laws of that country

The branch auditor, so appointed, will have the same powers and duties in respect of audit of account of branch office as the company's auditor possesses In addition, he shall prepare a report on the audited accounts and forward it to the company's auditor who shall, in preparing his report, deal with it in such a manner as he considers necessary

In case the accounts of the branch office have been audited by a person other than the company's auditor, the company's auditor shall have the following powers

(i) Right to visit the branch office, if he deems it necessary, and

(ii) Access to the books, accounts and vouchers of the company maintained at the office

In the case of the branch office of a banking company situated outside India, it shall be sufficient if the auditor is allowed access to such copies of, and extracts from the books and accounts of the branch as have been transmitted to the Head Office in India [section 228 (2)]

So far as the remuneration of the branch auditor is concerned, that may be fixed either by the company in its general meeting or by the Board of directors, if so authorised by the company in its general meeting

The Central Government *may exempt* any branch office from the application of the provisions of section 228 (1) mentioned above, relating to the appointment and qualifications of its auditor, to the extent specified in Companies (Branch Audit Exemption) Rules, 1961 But while granting such exemption, the Government would take into consideration all or any of the following matters

(*a*) The arrangement made by the company for the audit of accounts of the branch office by a person otherwise qualified for appointment as branch auditor even though such person may be an officer or employee of the company,

(*b*) the nature and quantum of activity carried on at the branch office during a period of three years immediately preceding the date on which the branch office is exempted from the provisions of this section,

(*c*) the availability at a reasonable cost of a branch auditor for the audit of accounts of the branch office,

(*d*) any other matter which, in the opinion of the Central Government, justifies the exemption of the branch office from the provisions of this section

The Central Government *may revoke* the exemption on the following grounds

(*a*) if there has been a contravention of any of the terms and conditions subject to which the exemption was granted,

(*b*) if there has been a material alteration in circumstances relating to the scrutiny, check or audit of the accounts of branch office on the basis of which the exemption was granted, and

(*c*) if for any other reason, the Central Government is satisfied that the exemption is no longer necessary or justified

Auditor's Duties (i) He should see that the provisions of

section 228 of the Companies Act, 1956 regarding the audit of the branch office accounts have been duly observed

(*ii*) He must satisfy himself that all the transactions of the branch office have been duly accounted and assets and liabilities etc, have been correctly shown in its Balance Sheet He should carefully examine that all the transactions between the Head Office and the branch office have been correctly recorded in the books of account Sometimes the Head Office sends goods to its branches above cost In that case he should see that 'branch stocks' and 'goods sent to branch' have been reduced to cost to ascertain the actual profit and give correct statement in the Balance Sheet

(*iii*) He must find out that nothing has been omitted from incorporation of the branch returns into the books of the Head Office

(*iv*) He should ascertain that proper returns have been sent by the branch office from time to time at intervals of not more than three months These returns must be complete and duly signed by the branch manager

(*v*) He should study the branch auditor's report and set in his report the necessary matter He will have to mention in his report that proper returns necessary for the audit have been received from the branches not visited by him

ANNUAL ACCOUNTS OF A COMPANY

Every company is under legal obligation to hold a general meeting every year which is called the annual general meeting The first annual general meeting of the company must be held within eighteen months from the date of its incorporation Subsequently, next annual general meetings must take place within fifteen months In special circumstances, the Registrar has been empowered to extend the time within which any annual general meeting shall be held, by a period not exceeding three months [section 210(4)] In the event of default by the company, the Central Government is empowered to call an annual general meeting

The auditor should note that in the annual general meeting all the business to be transacted shall be deemed special, with the exception of business relating to—

(*i*) the consideration of the accounts, Balance Sheet and the reports of the Board of directors and auditors,

(*ii*) the declaration of a dividend,

(*iii*) the appointment of directors in the place of those retiring, and

(*iv*) the appointment and fixation of remuneration of the auditors (section 173)

In every annual general meeting the Board of Directors have to present the annual accounts to the members of the company

The provisions of the Act, with regard to the Annual Accounts and the Balance Sheet of the company, are contained in sections 210 and 211 It may be noted that the period to which the account aforesaid relates is referred to in the Act as a "financial year" and it may be more or less than a calendar year, but it shall not exceed fifteen months It may, however, extend to eighteen months where special permission has been granted in that behalf by the Registrar [section 210(4)]

Under section 210, at every annual general meeting held in pursuance of section 166 relating to holding of such meetings, the Board of directors of the company shall lay before the company—

(*a*) a Balance Sheet as at the end of the period in the specified form, and

(*b*) a Profit and Loss Account for that period, which shall relate to—

(*i*) In the case of the first annual general meeting of the company, the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months ,

(*ii*) In the case of any subsequent annual general meeting it shall relate to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months, or in cases where an extension of time has been granted for holding the meeting by more than six months and the extension so granted

Section 211 deals with the form and contents of Balance Sheet and the Profit and Loss Account of the company It provides that every Balance Sheet of a company should be prepared in such a manner as to give true and fair view of the state of affairs of the company as at the end of financial year The Balance Sheet has to be drawn in the form set out in Part I of Schedule VI[1] or as near thereto as circumstances admit It may, however, be drawn in such other form as the Central Government may approve The Schedule gives certain instructions for the preparation of the Balance Sheet under the heading "Notes" and these instructions must be duly observed

Similarly, the Profit and Loss Account of a company should be drawn up so as to give true and fair view of the profit or loss of the company for the financial year Part II of Schedule VI[2] of the Act contain provisions as to the informations to be set in the Profit and Loss Account which must be duly observed

The exemption in this respect has been given to any insurance

1 Given at the end of the chapter.

2 Given at the end of the chapter

company or banking company, or any company engaged in the generation or supply of electricity or any other company for which forms of the Balance Sheet and the Profit and Loss Account have been specified by the Act governing them The Central Government is also empowered to exempt any company from compliance with the above requirements

Under this section a company shall not be deemed to disclose true and fair view if Final Accounts are not drawn up in the proper form and contain informations required by Schedule VI or as amended by any notification In case of companies governed by special laws the Balance Sheet and the Profit and Loss Account shall not be deemed to disclose true and fair view if they do not disclose matter required to be disclosed by the respective Acts

It is very important part of the auditor's duty to examine the contents of the Annual Accounts of the company so that he may be able to report to the members about the truth and fairness of the account He has—

(*i*) to ascertain that the assets and liabilities of the company have been stated in the Balance Sheet in accordance with the provisions of the Companies Act, 1956 They have to be shown in the prescribed order disclosing the various informations as required by the Act,

(*ii*) to verify the existence of the assets of the company at the date of the Balance Sheet,

(*iii*) to check up the values of various assets and liabilities of the company ; and

(*iv*) to see that there is no omission of the liabilities from the accounts of the company or, in other words, all the liabilities have been properly stated in the Balance Sheet of the company.

Presentation of Financial Statements in Column or Form Usually, the Profit and Loss Account and Balance Sheet are prepared in traditional T-form The Schedule VI to the Companies Act, 1956 also recognises only this method However, this method does not convey the entire information and the shareholders, who do not have basic knowledge of accounts, may not understand them clearly Therefore, many companies have obtained permission from the Company Law Board under section 211(1) of the Companies Act to present their final accounts in the column or form. It may be easily understood even by a layman, as it shows clearly how the profits have been earned or how the shareholders' funds increased or decreased. It states clearly the source and uses of funds

Authentication and Filing of Annual Return and Balance Sheet The copy of annual return to be filed with the Registrar shall be signed both by a director and by manager or secretary of the company, or if there is none of these, it shall be signed by the two directors

of the company, one of whom shall be the managing director (section 215) Three copies of Balance Sheet and Profit and Loss Account have also to be signed similarly (section 220)

Under section 159, every company, having a share capital, is required to file with the Registrar a return within 42 days from the day on which each of the annual general meeting is held This return should contain the particulars specified in Part I of Schedule V as they stood on that day, regarding—

(*a*) its registered office,

(*b*) the register of its members,

(*c*) the register of its debenture holders,

(*d*) its shares and debentures,

(*e*) its indebtedness,

(*f*) its members and debenture holders, past and present, and

(*g*) its directors, managing directors, managers and secretaries, past and present

In case the annual general meeting of the company has not been held for any year, the date of such meeting shall be construed with reference to the latest day on or before which it should have been held in accordance with the provisions of the Act, and the above mentioned requirements have to be fulfilled accordingly

Under section 220 every company have to file with the Registrar after the Balance Sheet and the Profit and Loss Account have been laid before a company at its annual general meeting, three copies of Balance Sheet and Profit and Loss Account together with three copies of all the documents which are required to be annexed or attached to them.

If the annual meeting of a company before which a Balance Sheet is laid does not adopt it, a statement of the fact with reasons therefore, shall be annexed to the Balance Sheet to be filed with the Registrar [section 220(2)]

NOTE—Part I of Schedule VI has been substituted by the Companies (Amendment) Act No 65 of 1960 and is as follows :

PART I—FORM OF BALANCE-SHEET

Balance-Sheet of (*Here enter the name of the company*)

As at... (*Here enter the date as at which the balance-sheet is made out*)

Instructions in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs (b)	Rs (b)	Rs. (b)	Rs (b)	
*Terms of redemption or conversion (if any) of any Redeemable Preference Capital to be stated, together with earliest date of redemption or conversion Particulars of any option on unissued share capital to be specified †Particulars of the different classes of preference shares to be given	*SHARE CAPITAL Authorised shares of Rs . . each †Issued (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class) shares of Rs each †Subscribed (distinguishing between the various classes of capital and stating the particulars		*FIXED ASSETS Distinguishing as far as possible between expenditure upon (a) goodwill, (b) land, (c) buildings, (d) leaseholds, (e) railway siding, (f) plant and machinery, (g) furniture and fittings, (h) development of property, (i) patents, trade marks and designs, (j) livestock, and (k) vehicles, etc		*Under each head the original cost, and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year to be stated In every case where the original case cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books shall be given For the purposes of this paragraph, such valua-

	Rs (b) specified below, in respect of which class) shares of Rs each Rs called up — Rs (b) (c)	Rs (b)	Rs (b)
	Of the above shares, shares are alloted as fully paid up pursuant to a contract without payments being received in cash		tion shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sales proceeds shall be shown as deduction
*Specify the source from which bonus shares are issued *e g*, capitalisation of Profits or Reserves or from Shares Premium Account	Of the above shares, shares are allotted as fully paid up by way of bonus shares		
	Less: Calls unpaid (i) By managing agent or secretaries and treasurers and where the managing agent or secretaries and treasurers are a firm by the partners thereof, and where the managing agent or secretaries and treasurers are a private company by the directors		Where sums have been written off on a reduction of capital or a revaluation of assets, every balance-sheet, (after the first balance-sheet) subsequent to the reduction or revaluation shall show the reduced figures and with the date of the reduction in place of the original cost Each balance-sheet for the

Instructions in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs		Rs	Rs		Rs	
	(b)	or members of that company	(b)	(b)		(b)	first five years, subsequent to the date of the reduction, shall show also the amount of the reduction made
‡Any capital profit on re-issue of forfeited shares should be transferred to Capital Reserve		(ii) By directors (iii) By others *Add* Forfeited shares (amount originally paid up)					Similarly, where sums have been added by writing up the assets, every balance-sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost Each balance-sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made
*Addition and deduction since last balance-sheet to be shown, under each of the specified heads					INVESTMENTS Showing nature of investments and made of valuation, for example cost or market value and distinguishing between— *(1) Investments in Government or Trust Securities		
The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments		*RESERVE AND SURPLUS (1) Capital Reserves not available for Dividend (2) Capital Kedemption Reserve			(2) Investments in shares, debentures or bonds (showing separately shares, fully paid up are partly paid up and		*Aggregate amount of company's quoted investments and also the market value thereof shall be shown Aggregate amount of company's unquoted investments shall also be shown

	(3) Share Premium Account (cc) (4) Other Reserves specifying the nature of each reserve and the amount in respect thereof	also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies (3) Immovable properties	
†Loans from Directors, Managing Agents, Secretaries and Treasurers, Managers should be shown separately Interest accrued and due on Secured Loans should to included under the appropriate sub-heads under the head "SECURED LOANS"	*Less* Debit balance in Profit and Loss Account (if any) (5) Surplus that is balance in Profit and Loss Account after providing for proposed allocations, *viz*, Dividend, Bonus or Reserves (6) Proposed additions to reserves. (7) Sinking Funds	CURRENT ASSETS, LOANS AND ADVANCES (A) Current Assets (1) Interest accrued on Investments ††(2) Stores and Spare Parts ††(3) Loose Tools ††(4) Stock-in-trade ††(5) Works in Progress	††Mode of valuation of stock shall be stated and the amount in respect of raw materials shall also be stated separately where practicable **Mode of valuation of working progress shall be stated
*The nature of the security to be specified in each case Where loans have been guaranteed by managing agents, secretaries and treasurers, manager and/	SECURED LOANS *(1) Debentures† *(2) Loans and Advances from Banks *(3) Loans and advances from subsidiaries	(6) Sundry Debtors. (a) Debts outstanding for a period exceeding six months (b) Other debts	†In regard to Sundry Debtors particulars to be given separately of—(a) debts considered good and in respect of which the company is fully secured, and (b) debts considered good for which the company

Instructions in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs	Rs	Rs	Rs.	
or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head	(b) *(4) Other Loans and Advances	(b)	(b) *Less* Reserve +(7) Cash and bank balances	(b)	holds no security other than the debtor's personal security, and (c) debts considered doubtful or bad
†Terms of redemption or conversion (if any) of debentures issued to be stated together with earlier date of redemption or conversion					
					Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated

			Debts due from other companies under the same management to be disclosed with the names of the companies (*vide* section 370)
			The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note
Loans from Directors, the Managing Agents, Secretaries and Treasurers, Manager should be shown separately Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "UNSECURED LOANS"	UNSECURED LOANS (1) Fixed Deposits †(2) Loans and Advances from subsidiaries †*(3) Short Term Loans and Advances (a) From Banks (b) From others †(4) Other Loans and Advances (a) From Banks (b) From others		Reserves to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such Reserves, if already created, should be shown at every closing under "Reserves and Surplus' (in the Liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts"
†Where loans have been guaranteed by managing agents, secretaries and treasurers, managers, and/or directors, a mention thereof shall also be	CURRENT LIABILITIES AND PROVISIONS A Current Liabilities (1) Acceptance (2) Sundry Creditors	†(B) Loans and Advances (8) Advances and Loans to subsidiaries (9) Bills of Exchange.	†The balance lying with bankers or current accounts, call accounts and deposit accounts shall be shown separately.

Instruction in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs (b)		Rs (b)	Rs (b)		Rs (b)	
made and also the aggregate amount* of such loans under each heads		(3) Subsidiary Companies			(10) Advances recoverable in cash or in kind or for value to be received, e g , Rates, Taxes, Insurance, etc		The above instructions regarding "Sundry Debtors" apply to "Loans and Advances" also
*See note (d) at foot of Form		(4) Provision for Taxation			(11) Balances on current account with Managing Agents or Secretaries and Treasurers		
		(5) Proposed Dividends			(12) Balances with Customs, Port Trust, etc (where payable on demand)		
		(6) Advance Payments and Unexpired Discounts for the portion for which value has still to be given e g , in the case of the following classes of companies · (Newspaper, Fire Insurance, Theatre, Clubs, Banking, Steamship Companies, etc)					
		(7) Unclaimed Dividends					
		(8) Other Liabilities (if any)					
		(9) Interest accrued and accruing on secured loans					

††The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class are in arrear, shall be stated	(10) Interest accrued and accruing on unsecured loan B Provisions (11) For contingencies (12) For Provident Fund schemes		
The amount shall be stated before deduction of Income-tax, except that in the case of tax free dividends the amount shall be shown free of income-tax and the fact that it is so shown shall be stated	(13) For insurance, pension and similar staff benefit schemes (14) Other provisions [A foot note to the balance-sheet may be added to show separately: - (1) Claims against the company not acknowledged as debts	MISCELLANEOUS EXPENDITURE (to the extent not written off) (1) Preliminary expenses (2) Expenses including commission or brokerage on under-writing or subscription of shares or debentures (3) Discount allowed on the issue of shares or debentures	
†The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified	(2) Uncalled liability on shares partly paid. ††(3) Arrears of fixed cumulative dividends (4) Estimated amount of contracts remaining to be executed on capital account and not provided for †(5) Other money for which the company is contingently liable	(4) Interest paid out of capital during construction (also stating the rate of interest) (5) Development expenditure not adjusted (6) Other items (specifying nature). PROFIT & LOSS ACCOUNTS Loss brought forward *Less* Reserves set off	Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any

NOTES

General instructions for preparing balance-sheet—

(*a*) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance-sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance sheet This is recommended when items are numerous

(*b*) *Naye Paise* can also be given in addition to Rupees, if desired

(*c*) In the case of subsidiary companies, etc , the numbers of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated

The auditors is not required to certify the correctness of such share-holdings as certified by the management

(*cc*) The item "Share Premium Account" shall include full details of its utilization in the manner provided in section 78

(*d*) Short-term Loans will include those which are due for not more than one year as at the date of the balance-sheet.

(*e*) Depreciation written off or provided shall be allocated under the different asset heads and deducted in arriving at the value of Fixed Assets

(*f*) Dividends declared by subsidiary companies after the date of the balance-sheet cannot be included unless they are in respect of period which closed on or before the date of the balance-sheet

(*g*) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance-sheet but shall be made in the Board's report

(*h*) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any

(*i*) As regards Loans and Advances, the amounts due from other companies under the management should also be given with the names of the companies vide section 370 , the maximum amount due from every one of these at any time during the year must be shown

(*j*) Particulars of any redeemed debentures which the company has power to issue should be given

(*k*) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated

(*l*) A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance-sheet showing the names of the bodies corporate, indicating separately the names of the bodies corporate in the same group (with the name of the managing agent or secretaries and treasurers, if any, of every body corporate) in whose shares or debentures Investments have been made (including all investments whether existing or not, made subsequent to the date as at which the previous balance-sheet was made out) and the nature and extent of the investments so made in each such body corporate : provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investment existing on the date as at which the balance-sheet has been made out , provided further that it shall not be necessary to give any particulars in respect of investments made by a managing agency or secretaries and treasurers company in the managed companies' shares or debentures

A "Trade Investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary for the purpose of promoting the trade or business of the first company

(*m*) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated

(*n*) Except in the case of the first balance-sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance-sheet shall be also given in the balance-sheet The requirement in this behalf shall in the case of companies preparing quarterly or half-yearly accounts, etc , relate to the balance-sheet for the corresponding date in the previous year

(*o*) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances

(*p*) Current accounts with Directors, and Managers, whether they are in credit or debit, shall be shown separately

PART II OF SCHEDULE VI

REQUIREMENT AS TO PROFIT AND LOSS ACCOUNT

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.

2 The profit and loss account—

(*a*) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account, and

(*b*) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature

3 The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads, and in particular, shall disclose the following information in respect of the period covered by the account —

(*i*) (*a*) The turnover, that is, the aggregate amount for which sales are effected by the company

[(*b*) Commission paid to sole selling agents within the meaning of section 294 of the Act

(*c*) Commission paid to other selling agents

(*d*) Brokerage and discount on sales, other than the usual trade discount]

(*ii*) (*a*) In the case of manufacturing concerns, the purchases of raw material, and the opening and the closing stocks of the goods produced

(*b*) In the case of trading concerns the purchases made and the opening and the closing stocks

(*c*) In the case of concerns rendering or supplying services, the gross income derived services rendered or supplied

[(*d*) In the case of a concern which fall under more than one of the categories mentioned under clauses (*a*), (*b*) and (*c*) above, it shall be sufficient compliance of the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases and sales and the gross income from services rendered is shown

(*e*) In the case of other concerns, the gross income derived under the different heads]

(*iii*) In the case of all concerns having works in progress, the amounts for which *Such works have been completed* at the commence-

ment and at the end of the accounting period

(*iv*) The amount provided for depreciation, renewals or diminution in value of fixed assets

If such provision is not made by means of a depreciation charge, the method adopted for making such provision

If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with section 205 (2) of the Act shall be disclosed by way of a note

(*v*) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, *paid or payable* to the managing director, the managing agent, the secretaries and treasurers and the manager, if any

(*vi*) The amount of charge for Indian income-tax and other Indian taxation on profits, including where practicable, with Indian income tax, any taxation imposed elsewhere to the extent of the relief if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation

(*vii*) The amount reserved for—

(*a*) repayment of share capital , and

(*b*) repayment of loans

(*viii*) (*a*) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions, made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made up

(*b*) The aggregate, if material, of any amounts withdrawn from such reserves

(*ix*) (*a*) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments

(*b*) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required

(*x*) Expenditure incurred on each of the following items, separately for each item —

(*a*) Consumption of stores and spare parts

(*b*) Power and fuel

(*c*) Rent.

(*d*) Repairs to buildings.

(*e*) Repairs to machinery

(*f*) (1) Salaries, wages and bonus

(2) Contribution to provident and other funds

(3) Workmen and staff welfare expenses *to the extent not adjusted from any previous provision or reserve*

Note—*Information in respect of this item should also be given in the balance-sheet under the relevant provision or reserve account.*

(*g*) Insurance.

(*h*) Rates and taxes, excluding taxes on income

(*i*) Miscellaneous expenses

(*xi*) (*a*) The amount of income from investments, distinguishing between trade investments, and other investments

(*b*) Other income by way of interest, specifying the nature of the income

(*c*) The amount of income-tax deducted if the gross income is stated under sub-paragraphs (*a*) and (*b*) above

(*xii*) (*a*) Profits or losses on investments *to the extent not adjusted from any previous provision or reserve*

Note—*Information in respect of this item should also be given in the balance-sheet under the relevant provision or reserve account*

(*b*) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount

(*c*) Miscellaneous income

[(*xiii*) (*a*) Dividends from subsidiary companies]

(*b*) Provisions for losses of subsidiary companies

(*xiv*) The aggregate amount of the dividends paid and proposed, and stating whether such amounts are subject to deduction of income-tax or not

(*xv*) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting

[4 The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors including managing directors, the managing agents, secretaries and treasurers or manager, if any by the company, the subsidiaries of the company and any other person —

(*i*) managerial remuneration under section 198 of the Act paid or payable during the financial year to the directors (including managing directors), the managing agent, secretaries and treasurers and manager, if any ,

(*ii*) expenses reimbursed to the managing agent under section 354 ;

(*iii*) commission or other remuneration payable separately to a managing agent or his associate under sections 356, 357 and 358 ,

(iv) commission received or receivable under section 359 of the Act by the managing agent or his associate as selling or buying agent of other concerns in respect of contracts entered into by such concerns with the company ,

(v) the money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under section 360 during the financial year ,

(vi) other allowances and commission including guarantee commission (details to be given) ,]

(vii) *any other prequisities or benefits in cash or in kind (stating approximate money value where practicable) ,*

(viii) *pensions, etc ,—*

(a) *pensions,*

(b) *gratuities,*

(c) *payment from provident funds, in excess of own subscriptions and interest thereon,*

(d) *compensation for loss of office,*

(e) *consideration in connection with retirement from office*

[4A The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors), the managing agents, secretaries and treasurers or manager (if any)

4B The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, or otherwise for services rendered—

(a) as auditor , and

(b) in any other capacity]

5 The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact

6 (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amount for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account

(2) The requirements in sub-clause (1) shall, in the case of

companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year

PART III

INTERPRETATION

7 (1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires—

(*a*) the expression "provision" shall, subject to sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy ,

(*b*) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability ,

(*c*) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account , and the expression "revenue reserve" shall mean any reserve other than a capital reserve ,

and in this clause the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities

(2) Where—

(*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act , or

(*b*) any amount retained by way of providing for any known liability ,

is an excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provisions.

8 For the purposes aforesaid, the expression "quoted investment" means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange and the expression "unquoted investment" shall be construed accordingly

QUESTIONS

1 How would you audit the accounts of a branch office of a company ?

2 Explain briefly the provisions of Companies Act, 1956, regarding annual accounts of a company

3 Explain briefly the requirements of Schedule VI to the Companies Act, 1956 regarding disclosure of the following items to the balance sheet of a company

(*a*) Reserves and surplus ,

(*b*) Expenditure incurred in respect of salaries and perquisites of employees ,

(*c*) Fixed assets

4 What is the information required to be given in a Profit and Loss Account by way of note regarding payments made to the directors, managing agent, and manager of the company

5 State the requirement of Schedule VI to the Companies Act, 1956 regarding disclosure of following items in the balance sheet of a company

(*i*) Share capital ;

(*ii*) Loans and advances ; and

(*iii*) Investments

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Holding Companies

A holding company is that which holds whole or more than half of the equity or ordinary share capital in one or more companies and thus assumes controlling interests in such companies by assuming majority voting powers in them The development of holding companies is quite marked in recent years and there are many such organisations today, even international in character, controlling large number of companies in countries all over the world In the words of De Paula, "One of the most marked developments in industry and commerce in recent years has been the advent of the holding company, that is an organisation comprising a parent company which holds a controlling interest in one or more subsidiary companies and in some cases sub-subsidiary companies "[1]

The holding company and the various subsidiary companies may be quite inter-linked by means of share-holding in each other, but it should be noted that each of them is a self-contained unit and has a separate legal entity Each company is governed by its own Board of directors If any creditor, for instance, has got a claim against a subsidiary company, he cannot legally have any claim against the assets of its holding company or any other company within the group.

According to section 4 of the Companies Act, 1956, a holding company is that which—

(*i*) holds more than 50 per cent of the nominal value of the equity share capital of another company , or

(*ii*) controls the composition of the other company's Board of directors , or

(*iii*) controls more than half of the total voting power of the other company ,

(*iv*) has a subsidiary, which is the subsidiary of that holding company's subsidiary, *e g* , there are three companies A, B and C If B is a subsidiary of A and C is subsidiary of B, then C will be subsidiary of A also C will be known as sub-subsidiary of A

It may, however, be noted that shares held or power of appoint-

1. *Op. cit.*, p. 246

ment held by the holding company in other company shall not be taken into account in the following cases

(a) when held in fiduciary capacity ,

(b) when held by virtue of terms of any debentures or debenture trust deed ,

(c) when held as security only, for moneys advanced to the other company in the ordinary course of business

Legal Requirements regarding Accounts etc The various provisions of the Act related to the holding companies have been given in sections 212, 213 and 214 and Schedule VI Part I We give them briefly as follows

(1) The Balance Sheet of the subsidiary shall be made out (a) as at the end of the financial year of the subsidiary, if it coincides with the financial year of the holding company, or (b) as at the end of the financial year of the sudsidiary last before that of the holding company, in case the financial year of the subsidiary does not coincide with that of the holding company

(2) The following items should be specifically mentioned in the Balance Sheet of the holding company related to its subsidiaries ,

(i) The aggregate amount of loans and advances to subsidiary company

(ii) The aggregate amount of investments in shares or debenture or bonds in subsidiary company

(iii) Secured loans and advances from subsidiaries

(iv) Unsecured loans and advances from subsidiaries.

(v) The aggregate amount of liabilities due to subsidiary companies

(The first two items have to be shown on the assets side and the last three items on the liabilities side of the Balance Sheet)

(3) The holding company shall at the end of the financial year attach to its Balance Sheet the following documents in respect of its subsidiary company

(a) a copy of the Balance Sheet of the subsidiary ,

(b) a copy of the Profit and Loss Account ,

(c) a copy of report of its Board of Directors ,.

(d) a copy of report of its auditors ,

(e) a statement of the holding company's interest in the subsidiary ,

(f) a statement containing any change in the holding company's interest in the subsidiary or any material change of the subsidiary in its fixed assets, investments, money lenf or borrowed etc ,

(g) a report attached to the Balance Sheet if the Board of directors of the holding company is unable to obtain information on any of the specified matters

(4) A statement should be there specifying how the profits of the subsidiary company or aggregate profits or losses of the subsidiary have been taken into accounts of the holding company Such statement would also specify how and to what extent, losses, if any, of the subsidiaries have been brought into the accounts of the holding company. Such statement shall be signed by the persons by whom the Balance Sheet of the holding company is required to by signed

(5) The Profit and Loss Account of the subsidiary must be made out within the period to which the accounts of the holding company relate But where the financial year of the subsidiary does not coincide with that of the holding company, the financial year of the subsidiary shall not end on a day which precedes the day on which holding company's financial year ends by more than six months

(6) The Central Government may exempt the holding company from the application of the provision with regard to attachment of various documents to the Balance Sheet It is empowered to extend the financial year so that it may coincide in both the cases

(7) The holding company may, by resolution, authorise named representatives to inspect books of account of any of its subsidiaries during business hours

(8) The members of the holding company may request the Government to appoint a person to investigate into the affairs of its subsidiaries.

(9) If the report of the auditor on Balance Sheet of the subsidiaries company is a qualified one, the statement mentioned above must mention it together with the particulars of the qualifications

Consolidation of Accounts Customarily, certain holding companies attach to their own Balance Sheet a consolidated Balance sheet to give a more detailed and clear picture of their subsidiaries Such consolidated Balance Sheet is definitely more useful than the separate Balance Sheet of each of the subsidiaries For this purpose, the whole group is regarded as one undertaking and hence the whole assets as well as liabilities of all the companies in the group are presented in *one* Balance Sheet The Profit and Loss Account of the whole group is also presented in the similar fashion. This enables the members of the company to get the entire picture at one place and ascertain the true position of the investments made by them

The limitation of the presentation of consolidated accounts is that it is impossible to find out which subsidiary is earning profit and which one is incurring loss and how much This may turn out to be a shield for the lapses of the management of some of the subsidiaries. But the presentation of the consolidated accounts becomes necessary,

specially in the circumstances when the periods of the Balance Sheets of different subsidiaries and the holding company do not coincide, so that a clear picture may be presented

The following points should, however, be kept in mind, while consolidating the accounts by a holding company

(i) The date of the Balance Sheets of all the companies should be the same If it is not so, efforts should be made to make adjustments so that the financial position of all the companies should be shown as on a particular date in the consolidated Balance Sheet.

(ii) The basis of valuation of assets or of bringing liabilities into account should be similar in all the cases

(iii) The 'shares in subsidiary companies' have to be adjusted by replacing them by actual assets and liabilities of the subsidiary companies In case the price paid for shares in the subsidiary companies is more than the actual 'net assets' of the subsidiaries, such excess should be shown as included in Goodwill in the consolidated Balance Sheet

(iv) If the shares in the subsidiary companies were purchased at a discount, such discount should be shown as deducted from the goodwill The debit balance in the Profit and Loss Account should also be added to the cost of goodwill because such loss will have the effect of reducing it

(v) In case a part of the shares of subsidiary companies is held by persons other than the holding company, their total interests should be shown as liabilities in the consolidated Balance Sheet

(vi) The loans taken by the subsidiaries amongst themselves or say, inter-company indebtedness, should not be shown in the consolidated Balance Sheet It should, however, be set off

(vii) Inter-company profits, if any, also should be adjusted by deducting from the Profit and Loss Account and related assets, if they are added therein Thus, in the consolidated Balance Sheet stocks etc should be combined together at cost

(viii) The proportion of profits or losses belonging to outside shareholders should be properly adjusted They should be deducted from the consolidated Profits and Loss Account and at the same time shown as liabilities in the consolidated Balance Sheet as they do not belong to the holding company

AUDITOR'S DUTIES

The duties of an auditor of a holding company with regard to its subsidiaries have not been extended by the Companies Act, 1956 He has to perform the same ordinary duties provided under the Acts as in the case of other companies The additional care which he has to take is to see that the provisions of sections 212, 213 and 214, as mentioned earlier, have been duly complied with.

He has no legal obligation to see that the holding company presents the consolidated Balance Sheet and Profit and Loss Account together with its own Balance Sheet stating in a summarised form the assets and liabilities of its subsidiaries In case it presents a consolidated Profit and Loss Account and Balance Sheet, he should welcome it

It is to be noted that the auditor of a holding company has nothing to do with the audit of annual accounts and Balance Sheet of its subsidiaries The latter, being separate legal entity have to prepare and publish the accounts and statements and get them audited by their own auditors

The auditor of a holding company, however, has to pay attention to the following points

(*i*) He should examine the contract of purchase and vouch the purchase considerations if he finds that during the year under audit, the company has purchased shares in a subsidiary company He should also see that the shares have been registered in the name of the holding company

(*ii*) He should examine and verify carefully the inter-company transactions He should ascertain that all such transactions have been properly recorded in the books of account of the holding company

(*iii*) He must verify the valuation of share in the subsidiary company quoted, held by a holding company Such shares have to be valued on the basis of cost or market price whichever is lower It would be easy if the shares are quoted in Stock Exchange But if they are quoted, he should ascertain their value with due regard to the value of the shares of the associated companies, the director's report or other available sources In any case, if he finds that the market value of the Shares has gone down, he must see that such shares have been written down to that extent Due attention should also be paid to any provisions with regard to valuation of shares given in the Memorandum and Articles of Association of the Company

(*iv*) He must vouch the dividends received from the subsidiary companies and see that they have been properly dealt with in the accounts He must see that only those dividends have been taken into account which have been properly declared as dividend by the subsidiary companies In case there is a loss, he must see that the provisions for such losses have been made in the accounts of the holding company

(*v*) He must examine that the requirements of Schedule VI of the Act, with regard to the disclosure of certain items related to the subsidiary companies separately in the Balance Sheet of the holding company have been duly complied with These items have already been mentioned earlier He must see that the number of shares in the subsidiaries have been clearly disclosed in the Balance Sheet of holding company

(*vi*) He must ascertain whether the subsidiary company is

indebted to the holding company and if it is so, he must be sure about the solvency of that subsidiary company and see that some provisions have been made in this connection by the holding company.

(*vii*) He must see that the Balance Sheet discloses the true and fair view of the financial state of affairs of the company He must exercise all reasonable care and skill and should take all necessary steps to ensure this He should examine and ascertain that the shares held in and indebtedness to any of the subsidiary companies have been shown separately in the accounts of the holding company In this connection he should also study the previous as well as current Balance Sheet and Profit and Loss Accounts of the subsidiary company

(*viii*) If he is not satisfied with regard to any matter, he must disclose the whole facts in his report

In case the *consolidated accounts* are presented to an auditor for his report, he should examine them very carefully He should see that the various points, noted earlier in connection with the preparation of consolidated accounts have been duly observed, besides, he should pay attention to the following points

(*i*) Ascertain that proper adjustment has been made in case the consolidated accounts of various companies have not been made up as on a particular date For instance, Balance Sheet of A has been prepared as on 31st December, whereas that of B as on 31st March

(*ii*) Ascertain that proper adjustment has been made in the consolidated Profit and Loss Account in connection with the dividends paid to holding companies by their subsidiaries

(*iii*) Note that the holding company has not paid any dividends to its shareholders out of the dividends received from its subsidiaries provided such dividends were paid out of the 'pre-acquisition profits' of the subsidiaries In case such payment has been made, see that this fact has been stated in clear words to bring to the notice of the shareholders

(*iv*) Check the amount retained, if any by the subsidiary company to the extent in affects the holding company For this, relevant accounts of the subsidiary company have to be referred See that such amount has been deducted in the consolidated Profit and Loss Account from the profits of the whole group

(*v*) See that inter-company profits not realised to that date have not been included.

(*vi*) Ascertain that the basis of valuation of various assets of different companies which have been consolidated is the same

(*vii*) See that proper adjustment has been made for revaluation, if any, of the assets of any subsidiary company Ascertain that depreciation by reference to such revaluation has been duly charged

(*viii*) Ascertain that all the adjustment to the amount of goodwill, as necessary, have been made properly See that the

goodwill shown in the consolidated Balance Sheet has been correctly computed

(*ix*) See that the liabilities related to the shares held by outside shareholders have been properly shown

(*x*) Check the adjustments, if any, in connection with the inter-company liabilities

(*xi*) Ascertain that the consolidated Profit and Loss Account and Balance Sheet present the complete and clear picture of earnings and financial position of the various companies taken together Any discrepancy revealed must be brought to the notice of the share-holders.

QUESTIONS

1 What is a holding company ? Explain the legal provisions regarding accounts of a holding company ?

2 Discuss the duties of an auditor regarding audit of accounts of a holding company

3. To what points you would pay special attention, if consolidated accounts are presented to you for your report as an auditor ?

4 Briefly describe provisions of Companies Act, 1956 regarding accounts of a holding company.

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Profits and Divisible Profits

PROFITS

(The primary motive behind running a business undertaking is to earn profits) It is true in all cases whether it is a business owned by an individual or partners or it is a joint stock company The profits earned during a particular period have to be ascertained in each case In case of business owned by individuals or partners, it is not so important a question as to how the profits should be ascertained The proprietors are free to choose any method they like and the parties other than the proprietors are not much interested in profits or their computation

But the proper ascertainment of profits is of great importance in case of a joint stock company where other parties who have to deal with it are also interested as to how its profits are determined The prospective shareholders of the company, the debenture holders, the creditors, the directors, the management and other employees and tax authorities etc , all are interested in its profits and their computation That is why it is necessary in case of a company that the profits should be properly ascertained

No definite meaning has been assigned to the word 'profit' Economists and accountants differ and even the accountants differ amongst themselves as to its correct meaning To an economist, it may mean "the increase in the value of total net assets of a business over a period of time after making allowance for the withdrawal or introduction of the capital" To an accountant it is the margin between "operating income and associate outgoings as related to a given period of time" In simple words, the profits for a given period may be said to be the excess of current incomes over current expenditures, after making good any loss sustained by fixed or current assets during that period in process of earning such incomes. "Profits," as stated by Lord Herschell, "are ascertained by setting against the income earned, the cost of earning it "[1]

The question of ascertainment of profits was considered in detail in an important case, namely, *re Spanish Prospective Co Ltd* (1911) The learned judge stated that " if the total assets of the business at two dates be compared, the increase which they show at the later

1. Lord Herschell in *Gresham Life Assurance Society Vs Styles*, 1892

date as compared with earlier date (due allowance, of course, being made for any capital introduction into or taken out of the business in the meanwhile) represents, in strictness, the profits of the business during the period in question "

Consequences of Incorrect Calculation If the profits or losses of a company are not properly ascertained and wrongly calculated, it will have the following consequences

(*i*) If the calculated profits are more than the actual, it may result into distribution of dividends out of capital assuming that the entire profits are distributed as dividends But it is illegal to pay dividend out of capital, since it would amount to reduction of capital which is prohibited under section 100 of the Companies Act, 1956 Under such circumstances the directors of the company will be jointly and severally held liable for it to the extent the dividends are paid out of capital. They will, however, be not held liable if such dividends are paid after the *bonafide* valuation of the assets of the company or if they relied on the trusted officials of the company

(*ii*) Over-statement of profits and consequent distribution of dividends out of the capital would be against the interest of the creditors and the debenture-holders It would result into depletion of assets and would thus reduce the security given to them

(*iii*) Persistent overstatement of profits and distribution of dividends out of capital would go on depleting its assets and ultimately it may drain the resources of the company resulting into its liquidation

(*iv*) If profits are understated, it will affect the present shareholders, since it will reduce the amount of dividends paid to them to the extent the profits are understated That will, in turn, have the effect of depressing the market value of their shares.

(*v*) The understatement of profits also affects the interest of the directors, managers, managing directors etc, since sometimes part of the remuneration they receive is determined on the basis of the net profits of the company In such a case they will receive less remuneration

(*vi*) Incorrect determination of profits would affect the Balance Sheet which would not represent the correct value of the various assets etc. This may also affect the value of shares disclosed therein

Factors responsible for incorrect calculation of Profits While we have emphasised the importance of proper and correct ascertainment of the company profits, it is not easy to do so in practice It is difficult to calculate the correct amount of profit with mathematical exactitude In the accounts we enter various transactions which are of intangible nature and correct valuation in those cases is not possible Even in case of tangible assets exact value cannot be ascertained and it has to be estimated on certain generally accepted conventions Similarly, at times we have to depend upon various estimations and guesswork and it is well-known that estimates are at best only *estimates*.

We give examples of such factors which may vitiate the accuracy of the profit figure

(a) *Intangible assets* No uniform method of valuation of various intangible assets such as goodwill, patent or copyrights etc, has yet been developed and various methods are employed in various industries Different units in the same industry also do not follow similar procedure There is difference of opinion even amongst the various accountants whether such assets should be allowed to appear in the books or not This affects the profits a great deal depending upon how much amount is charged to Profit and Loss Account with a view to write them off

(b) *Fixed assets* The commercial practice for the valuation of fixed assets is to value them at cost price and to ignore the market value But since they depreciate by use and the passage of time, an estimated amount of depreciation is charged This charge for depreciation is always made on the basis of estimations The various elements involved in the estimation of depreciation, like the life of the asset, its scrap value, obsolescence etc, cannot be exactly ascertained They can simply be estimated Because of such estimation the correct calculation of the profits of the company cannot be made.

(c) *Stock* No uniform method is followed for the valuation of stock also Accountants agree on the principle that they should be valued at cost or market price, whichever is lower, but the "cost" or "market value" has different meanings to different concerns Such divergence of opinion affects the reliability of the profit figure a great deal

(d) *Deferred revenue expenditures* Such revenue expenditures, advantages from which will be derived in several subsequent years, are not uniformly treated in the accounts In some cases they are written off in the year in which they are incurred, placing a huge burden on the profit and loss of the company, in others they are written off in several years but there is no uniform practice as to over how much period they should be written off This also affects the calculation of correct amount or profits

(e) *Taxation.* This also presents an element of uncertainty in the accounts since the charge for taxation in the accounts has to be made on the basis of estimates It is because the law of taxation is very complex and these estimates may or may not be accepted by the Income-tax authorities

(f) *Reserves* Most of the companies create reserves and funds for certain contingencies and probable and unknown liabilities But the necessity of creating such reserves is not realised by every company and consequently the practice differs in this case also affecting the calculation of profits

(g) *Capital and Revenue items* It is still a problem to ascertain correctly whether certain items are capital or revenue It turns out to be greater problem in case a part of the total amount spent may

relate to revenue and the other to capital expenditure It poses, then, a problem as to on what basis the apportionment between capital and revenue be made

DIVISIBLE PROFITS

The term 'divisible profits' has a different meaning It relates to those profits which can be legally distributed amongst the shareholders of a company by way of dividend In *Fisher Vs Black and White Publishing Company*, 1901, it was stated that "Profits available for dividend" means "net profits after making any deductions which the directors can duly make" All the profits of a particular period are not distributed to the shareholders A part of this is set aside for reserves etc as decided by the directors, and only the remainder is divisible But the profits may consist of profits arising from trading as well as from other sources As we shall see, they may include even the capital profits which may also be distributed in the form of dividends under certain circumstances

The Companies Act, 1956 does not lay down the definition of "divisible profits" It simply provides under section 205 that no dividend shall be declared or paid except out of profits of the company arrived at after providing for depreciation or out of the money provided by the Central or State Governments for the payment of dividends in pursuance of the guarantee given by such Governments Since the Act is not definite on the subject, difficulties have arisen on the point

In the British Courts, the matter had been referred several times and the Courts have given their vendicts on the merits of the particular circumstances of each case But the rulings appear to be contradictory in some cases and no generalisation is possible Therefore, the case laws are also not much helpful, at best they may be used as an indicator that in similar circumstances the Court may take a particular view

Principles The following basic principles in connection with the divisible profits may be noted

(*i*) Capital must never form part of divisible profits , and

(*ii*) Only bonafide surplus or profits should be divisible amongst the shareholders

The company's Memorandum and Articles of Association and provisions of the Companies Act in this connection must be complied with "In every individual case in practice, the provisions of the Memorandum and Articles of Association of a company are of the utmost importance when considering the question of the divisible profits "[1]

However, the commercial and the legal viewpoints must not be confused. Sound financial plan requires that "all the losses, whether

1 F R.M de Paula, *op. cit* , p. 198

of revenue or capital, and whether accruing in respect of fixed or floating assets should be made good" before the distribution of dividends out of profits But legally it is not necessary to do so It has been rightly remarked that "The profits arrived at on a prudent commercial basis may be much less than those *legally* divisible, although there are cases where the excess of current income over current expenditure is not wholly divisible profit "[1]

PROVISIONS OF COMPANIES ACT

Main provisions of the Companies Act, 1956 regarding divisible profits are as follows

(*i*) A company must charge depreciation, under Section 205, if it wants to pay dividends

(*ii*) Dividends[2] can be paid out of three sources (a) from current profits after providing for depreciation, (b) from past profits or reserves only in accordance with the rules framed by the Central Government in this behalf under Section 205-A(3) of the Act, and (c) out of moneys provided by the Central Government or a State Government for payment of such dividends in pursuance of guarantee given by that Government

(*iii*) After the commencement of Companies (Amendment) Act (1974), *i e* from February 1, 1975, a company is required to transfer a prescribed percentage of its profits (not exceeding 10 per cent) to its reserves before declaring dividends

PROVISIONS OF INCOME-TAX ACT

While making payment of dividend, some provisions of Income-Tax Act have also to be kept in mind It may, however, be noted that those provisions do not make the dividends illegal Sections 104-109 of the Act provide that a company in which the public are not substantially interested has to distribute a specified amount as dividends, as prescribed under the Act The company would be required to pay additional income-tax on the undistributed part of its income, if the actual dividends fall short of the amount so prescribed

Provision of *Banking Regulation Act* also affect divisible profits. Section 17 of the Act provides that a banking company incorporated in India *must* transfer 20 per cent of its annual profits to a reserve fund before payment of dividend However, the bank may obtain exemption from the Central Government in this regard

FACTORS AFFECTING DIVISIBLE PROFITS

The statutory provisions do not help us in understanding clearly the problems posed by the following factors affecting divisible profits.

1. Taylor and Perry, *op cit* , p 248
2 For details, see next Chapter

We have to seek answers to those questions through a number of important cases on the subject decided by the British Courts But in practice the application of the ruling given by the Courts has to be made cautiously as it is only in identical circumstances that those ruling would be valid

(1) Capital Profits In practice the problem often arises whether the capital profits are also available for distribution along with the revenue profits In general, the capital profits are not available for distribution By capital profit we mean, a profit not earned in the normal course of business For instance, a machinery with a book value of Rs 20,000 is sold for Rs 30,000, then there would be a capital profit of Rs 10,000 But under certain circumstances, as decided in the cases given below, they may also be distributed **The Companies Act, 1956** does not prohibit their payment as dividend However, distinction should be made between the distribution of capital profits in the form of bonus shares and in the form of cash dividends It is to be noted that the capital profits may always be distributed in the form of bonus shares since it does not affect the assets of the company in any way

A distinction may also be made between capital profits and capital receipts The capital receipts cannot be distributed as dividends at all For instance, amount received on account of share premium a profit on reissue of forfeited shares is a capital receipt, and cannot be paid by way of dividend

In *Lubbock v The British Bank of South America* (1892)[1] it was held that "A profit made on the sale of a part of the undertaking of a company is available for dividend, if the Articles so permit " In this case, the company had sold its branches in Brazil, but later repurchased them at a profit There was a surplus of £ 205,000 in it

In *Foster v The New Trinidad Lake Asphalte Company, Ltd* (1901), it was held that "a realised appreciation in the value of a book debt taken over by a company at its formation is not profit available for dividend, unless such surplus remains after a revaluation of the whole of the assets "

On the basis of the analysis of the above decisions and the general practice in this connection, it is established that following conditions must be fulfilled to make the capital profits divisible

(i) The Articles of the company do not prohibit such distribution

(ii) The capital profits must have been realised

(iii) The surplus profits remain even after the revaluation of all the assets of the company

1 For details of this and other cases cited in the chapter, refer to Appendix 1

(iv) All the capital losses have been met and their distribution of the shareholders does not affect the payment of the debts of the company

It may be noted that the payment of capital profits to shareholders does not amount to payment of dividends out of capital We must distinguish between 'capital' and 'capital profits' clearly Lord Lindley rightly asserted ' Moreover when it is said and said truly, that dividends are not to be paid out of capital the word 'capital' means the money subscribed persuant to the Memorandum of Association, or what is represented by that money Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders "[1]

Another controversy in this connection is whether the capital profits may be utilised for writing off the debit balance of the Profit and Loss Account arising in prior periods so that the divisible profits may be abailable to the shareholders out of the current profits Legally, a company can do so, provided there is a *bonafide* revaluation of the assets and the capital profits might have arisen on account of that

It was held in *Ammonia Soda Co v Arthur Chamberlain & others*, (1918) that the capital profits arising from a *bonafied* revaluation of the fixed assets may be utilised by the director of a company to pay dividends during a current year without making good existing deficiencies in paid-up capital, or without writing off a debit to the company's Profit and Loss Account, occasioned by losses in previous years

(2) **Capital Losses** Loss on capital may arise because of depreciation of capital assets or loss on sale of such assets The question is whether a company which has lost part of its capital may declare or pay dividend without first making good the capital which has been lost From a legal point of view, the profits are divisible out of current profits to the shareholders without making good the loss on capital But this does not apply to a banking company According to section 15 of the Banking Companies Act, 1949, a banking company cannot declare dividends without making good the capital losses The following cases may be mentioned in this connection

In *Bolton v Natal Land and Colonisation Company Ltd* (1892), it was held that a company is under no legal obligation to make good the loss of capital before declaring dividends out of the current profits The Court felt that "assuming that a part of the capital had in fact been lost and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of dividend "

In *Verner v General & Commercial Investment Trust Ltd* (1894), the value of the securities held by the company went down considerably and a part of the deficiency was estimated to be dead loss and

1. *Verner v. General and Commercial Investment Trust* (1894)

totally irrecoverable Even then the company wanted to distribute the dividends out of the current profits without making good such deficiencies It was held that although this course might sometimes be imprudent, there was no law which prevented such distribution of dividends in all cases and under all circumstances Lindley, L J, observed "fixed capital may be sunk and lost, and yet the excess current receipts over payments may be divided, but the floating or circulating capital must be kept up"

(3) **Depreciation** Earlier, there was a controversy whether depreciation should be charged before the distribution of dividends out of profits But the provisions in the Companies Act, 1956[1] have set all these controversies at rest and now it is compulsory for all the companies to charge depreciation before it can pay dividends to the shareholders

Section 205 of the Companies Act, 1956 specifically provides that no dividends can be declared or paid except "out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of section 205 (2)" It clearly implies that the depreciation must be provided for, if dividend has to be declared or paid

The rules for provision of depreciation have been described under section 205 (2) According to it, the depreciation should be charged, as follows

(a) Depreciation must be charged at the rates prescribed for different assets by the Income Tax Act, 1961 and the Rules framed thereunder (Section 350) The depreciation should be charged with reference to the written down value of the assets as shown by the books of the company at the end of the financial year This allows use of diminishing balance method

(b) It may be calculated at a rate determined by dividing 95 per cent of the original cost of the asset to the company by the specified period in respect of such assets This is the same as the straight line method

(c) It may be charged on any other basis, provided it has been approved by the Central Government

(d) In case the company holds such other depreciable assets, for which no rate of depreciation has been provided by the Income Tax Act, 1961 or the Rules framed thereunder, the depreciation should be charged on such basis as may be approved by the Central Government

Regarding the *arrears of depreciation*, it has been provided under section 205 (1) that in case a company has not provided for depreciation for any financial year or years ending after 28th December,

1. For details see Chapter 13.

1960, it shall make provision for depreciation before declaring or paying dividends

(a) either out of profits of that financial year, or

(b) out of profits of any other previous financial year or years

But there are two exceptions to the above rules They are as follows

(i) The profits of a financial year (or years) which fall before the commencement of the Companies (Amendment) Act, 1960, may be distributed even though no provision for depreciation was made before arriving at the profits

(ii) The Central Government has been empowered to permit a company not to make provision for depreciation, in the interest of the general public

Thus, it is quite clear that the provision for the depreciation has to be made by every company if it wants to declare or pay dividends to its shareholders

The legal cases decided in this connection are not very helpful as they had created controversies in this regard In some cases, it was held that the depreciation should be charged whereas in others it was decided that there was no need to charge depreciation before payment of dividends out of profits Thus, those cases are or academic interest only

In the case of *Crabtree Thomas vs Crabtree* (1912), it was held that in case of a manufacturing concern, the capital equipment consists chiefly of plant and machinery and the company has to carry on business indefinitely Therefore, the depreciation of machinery must be charged before the calculation of the divisible profits In this case, the trustees were authorised to carry on the business left by the testator and to give the profits arising therefrom to the testator's wife during her lifetime A depreciation was charged to the extent of 7 5 per cent on the original cost of the machinery before the profits were arrived at The wife of the testator brought an action against this and took the plea that no depreciation should be provided on plant and machinery But it was held, as mentioned earlier, that depreciation can be charged before arriving at the amount of divisible profits

A different view was taken in the case of *Verner vs General and Commercial Investment Trust Ltd* (1894) It was held in this case that a company may pay dividends if it is solvent and is acting within its articles even though the capital of the company is not in-tact

In this case, the Trust had invested £ 900,000 (raised through share capital and borrowings) in various securities authorised by the Memorandum of Association The market value of such investment

fell by £ 75,000 and there was no prospect of recovering the same In during 1894, the concern had an excess of receipts over expenditures to the extent of £ 23,000 The point in question was whether the company could pay dividend without making good the loss of capital of £ 75,000

It was held by the learned judges Lendley L J, and A L Smith that the company could pay dividend without making good the loss on capital They stated that a company which has lost a part of its capital "can declare or pay a dividend without making good the capital which has been lost Such a proceeding may sometimes be very imprudent but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles" It was further stated that "Fixed capital may be sunk and lost, and yet the excesses of current receipts over current payments may be dividend, but floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess in which case, to divide such excess without deducting the capital which form part of it, will be contrary to law "

Similarly, in case of *Lee vs Neuchatel Asphalte Co. Ltd* (1889), it was held that a company, if so permitted by its Articles of Association, can declare dividend without making good the depreciation on the wasting assets In this case, the action was brought by Mr Lee on behalf of himself and all other ordinary shareholders with a view to restrain the company from the payment of dividend to the preference shareholders without first making provision for depreciation on the assets of the company

It was held that there was nothing in the Companies Act to prohibit a company formed to work a wasting property from distributing as dividend the excess of proceeds of working over expenses of working nor to impose on the company any obligation to set apart a sinking fund to meet the depreciation in the value of the wasting property Justice Lindley, in the course of his judgment stated that "It has been very judiciously and properly left to the commercial world to settle how the accounts were kept The Acts do no say what expenses are to be charged to capital account and what to revenue account, . I know of no obligation imposed by law or statute to create reserve fund out of revenue to recoup the wasting nature of capital Subject to any provisions to the contrary contained in the Articles I believe the disposition of the revenue is entirely in the hands and under the control of the company"

Thus, it is quite clear from the decisions in the above cases that there is no agreement on the issue of provision of depreciation in them However, as stated earlier, now these cases are of academic interest only as the Companies Act, 1956 has clearly stated that dividend cannot be paid unless the depreciation is duly provided for

(4) **Pass Losses** A problem often arises whether a company must meet out past revenue losses before the distribution of profits to the shareholders out of the current profits Legally, the position is

that there is no need for making good a debit balance on the Profits and Loss Account on account of the losses in the previous years before the distribution of current profits

In the *Ammonia Soda Company Ltd v Arthur Chamberlain and Others* (1918), it was held that "it is not necessarily illegal for directors of a company to pay dividends out of the profits of the company during a current year without making good existing deficiencies in paid-up capital, or without writting off a debit to the company's Profits and Loss Account occasioned by losses in previous years"

In this case, the directors of the company, Mr Chamberlain and Mr Cocking appreciated the value of land of the company to write off a debit balance im the profit and loss account amounting to £ 19,028 The value of land was raised by £ 20,542 and this sum credited to a reserve account It was later used to write off the debit balance, as mentioned above In the subsequent year, the company earned profits and declared a dividend amounting to £ 15,669 The plaintiff alleged that the revaluation of land was not justified for paying dividends It was also argued that the profit and loss account was continuous account which was always open and that there was no profit on it until all past losses had been written off Therefore, the directors were required to refund the money paid by way of dividends

It was held by the learned judges, Swinfen Eady and Warrington that "where a company has made losses in the past years and then makes a profit out of which it pays dividend such a dividend is not paid out of paid up capital If it were the paid up capital would be still further reduced by the payment In fact, the assets presenting the paid-up capital remain the same or of the same value as before the payment of dividend"

About past losses there are provisions under the **Companies Act, 1956** also Under Section 205 (1) (b), it has been provided that if a company has incurred a loss in any financial years falling after the commencement of the Companies (Amendment) Act, 1960, then either the amount of loss or on amount equal to the amount provided for depreciation whichever is less, shall be set off against the profits of the company before the dividend could be declared by the company concerned It implies that the past losses to the extent they are due to depreciation are to be provided for before payment of dividend out of the current profits It has made a distinction between the past losses due to depreciation and due to other expenses It has been, however criticised by the authorities on the subject It has been rightly stated in this connection that "It seems that the law regarding the provision of post losses only to the extent they are attributable to depreciation is illogical and inconsistent with the principles of sound finance There seems to be no essential difference between losses caused by depreciation and losses caused by other expenses like wages or cost of raw material etc Any loss results in the erosion of capital So one c[illegible]sist that the capital should be kept

intact before dividends can be declared, *i e.*, after all past losses have been made good "

The provision, in this regard would be clear with the help of the following example ·

Year	Profit/Loss before depreciation	Depreciation	Profit/Loss after depreciation
	Rs	Rs	Rs
1975	(15,000)	10,000	(25,000)
1976	8,000)	12,000	(4,000)
1977	10,000	15,000	(5,000)
1978	50,000	20,000	30,000

In the above case, the company can declare dividends only in 1978, but it can be done only when the loss on account of depreciation or amount of loss, whichever is lower, is written off Therefore, the company can declare a dividend of Rs 11,000 only in 1978 after meeting the past losses, as explained below

Rs.	10,000	for the year 1975	(the amount of depreciation being lower)
Rs.	4,000	for the year 1976	(the amount of loss being lower)
Rs.	5,000	for the year 1977	
Rs.	19,000	Total	

Thus, the total amount to be written off on account of past losses, as explained above, is Rs 19,000 and out of the current profits of Rs 30,000 in 1978, only the balance money, *i e*, Rs. 11,000 can be distributed by way of dividends to the shareholders of the company

(5) **Reserves** The position with regard to the creation of reserves out of the profits of the current year prior to the distribution of dividends is that the directors are free to create them provided the Articles of Association of the company so required In *Bond v Berrow Haematite Steel Company Ltd* (1902), it was held that the Preference shareholders cannot claim dividends as a matter of right before the provision of reserves, which the directors thought necessary, were duly made, provided the Articles give power to create reserves before the payment of dividends

(6) Profits prior to Incorporation of the Company Profits prior to incorporation of the company cannot be legally distributed amongst the shareholders The reason is that the company had not come into existence till the date of incorporation in the eyes of law even if it had been purchased earlier And if the company did not exist legally,

there is no question of the distribution of profits prior to its incorporation It is to be noted that the Companies Act is silent on this point, and does not contain any express provision in this respect.

GENERAL CONCLUSIONS

We may now draw certain guidelines and general conclusions on the subject

(*i*) What are divisible profits would depend upon the particular circumstances of each case

(*ii*) It is not necessary that a company should distribute the whole of its profits calculated in a particular year

(*iii*) Ordinarily, dividends are to be paid out of the trading profits but they may also be paid out of capital profits under certain circumstances

(*iv*) Directors may be held liable jointly and severally to repay the amount if they authorise the payment of dividend out of capital They will also be guilty of breach of trust

(*v*) Dividends can never be paid out of capital of the company. The Companies Act does not lay down that capital should be kept in intact but it does not mean that a part of the capital may be returned to the shareholders by way of dividends

(*vi*) Capital profits, if realised, may be distributed by way of dividend to the shareholders of the company it permitted by the Articles of Association But care should be taken to show them separately in the Profit and Loss Account so that they may not be mistaken to be a part of the trading profits

(*vii*) In case of a manufacturing concern the depreciation of Plant and Machinery must be provided for before the payment of dividend out of the profits of the company

(*viii*) Loss on the floating or circulating assets must be provided for before the distribution of dividend

(*ix*) In general, the provision for the depreciation of fixed assets is not required legally but the Court may determine for such provision with due regard to the nature of the business, the regulations of the concerns and other circumstances But it is compulsory in case of a company

(*x*) The merit of particular circumstances and the internal regulations of the company will decide whether the capital previously lost should be replaced or not However, it is necessary for the company to retain sufficient amount of assets to enable it to pay off the debts and other liabilities before the declaration of dividends

(*xi*) Subject to the approval of the shareholders, the bonafide revaluation of the assets is always allowed

(*xii*) If an increase in the value of fixed assets of a limited company results into surplus that may be distributed by way of

dividend provided such surplus occurred after a revaluation of the assets and the liabilities of the company taken together Also, such capital profit ought to have been realised in cash and distribution of dividends should not be prohibited by the Articles of the company

(*xiii*) Past losses of the company need not necessarily be made good before the payment of the dividends out of the current profits

AUDITOR'S DUTIES

The auditor's position with regard to the divisible profits is quite simple He has nothing to do with the prudence or imprudence of the conduct of business He is also not concerned with the policy decisions of the company The extent to which profits may be divisible out of the profits of the company has to be decided by the directors and the auditor cannot question their authority in this regard He may simply give his advice, if called upon to do so

His duties are to see that the provisions contained in the Memorandum of Association and the Articles of the company and statutory provisions in this respect have been duly complied with He has also to satisfy himself with regard to the proper presentation of facts in the accounts of the company If he finds any lacuna in the presentation of the accounts to the shareholders, he must inform them about it For example, if he finds that the provision for depreciation has not been made before the distribution of dividends or a part of the capital of the company is returned to the shareholders, he must report the matter to the shareholders without fail If he finds certain deficiency in the accounts, his responsibilities are over if he reports this fact to the shareholders

QUESTIONS

1 What do you understand by 'profit'? What are the consequences of incorrect calculation of profits?

2 What is the difference between 'profits' and 'divisible profits'?

What factors affect the correctness in calculation of profits?

3. What are 'divisible profits'? Briefly explain the principles underlying it

4 Define divisible profits and discuss the factors which affect them

5. What are capital profits? Are they available for distribution as dividend?

6. What are divisible profits? Are capital profits available for dividends?

7 "A company may distribute dividends without making good the past losses " Explain it fully

8 Distinguish clearly between profits and divisible profits Explain the auditor's duties regarding the divisible profits

9 "Is it necessary for a company to make provision for depreciation before distribution of dividends " Explain it and discuss auditor's duties in this connection

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Dividends

Dividends, as commonly understood, are that part of profits which is received by shareholders of the company on the amount of capital invested by them They are normally declared and paid at the end of the financial year

Powers of Directors and Shareholders Usually the Articles of Association give discretionary power to the directors to recommend for the payment of dividend to the shareholders as they think proper in the interest of the company They may not recommend any dividend and set aside the whole of the profits to the reserves They may also carry forward any part of the profits as they think fit In *Bond v The Barrow Haematite Steel Co Ltd* (1902) it was held that the preference shareholders cannot compel the directors to pay preference dividends as a matter or right even though the profits were available, if the directors thought it proper to transfer the profits to the reserves Mention here may be made to regulation 85 of Table A of the Companies Act, 1956 It provides that "the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board"

Thus it may be observed that the shareholders can sanction the rate of dividend in the general meeting of the company within the limits recommended by the directors If the directors recommend for the distribution of dividends at the rate of 6%, the shareholders will have to accept this limit They can, however, reduce this limit but cannot increase it They have to pass a resolution sanctioning the dividends without which they have no right to receive them Dividends may be paid only to the registered shareholders of the company or to their order or to the bankers of the shareholders or, in case of the share warrants, to the bearer of such warrants or to his bankers (section (205)

A company which has declared the dividend must pay it within forty-two days or the warrants in respect thereof must be posted within forty-two days from the date of the declaration (Section 207) If this provision is not complied with, every officer of the company is punishable with simple imprisonment for a term which may extend to seven days and shall also be liable to a fine.

In the following cases, however, they will not be held liable

(a) Where the dividend could not be paid by reason of the operation of any law ,

(b) where a shareholder has given direction to the company regarding the payment of the dividend and those directions cannot be complied with ,

(c) where there is a dispute regarding the right to receive any dividend ,

(d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder ,

(e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company

It may be noted that the dividend, once declared by the members of the company in its annual general meeting, become debt and the shareholders may sue the company for the payment of such dividend (*Savern v Wye Railway Co* , 1896) It is essential that the unpaid dividends must appear as a liability in the Balance Sheet But this does not apply to interim dividends which may be cancelled before they are actually paid

At the same time, as noted below, if dividend is knowingly paid out of capital, it can be recovered from the shareholders and the directors would be liable to refund the amount with interest

Dividends and Capital. One basic principle in this connection is that *dividends can never be paid out of capital* The provisions of the Companies Act, 1956 also subscribe to it If the Articles of a company contain any express provision in contravention of this fundamental principle, it will be *ultra vires* It is accepted by all that the original capital contributed by the shareholders must be kept in tact

If the dividends are paid out of capital of the shareholders, it would result into depletion of assets of the company purchased with the paid-up capital This would leave the creditors helpless on account of the dwindling of the security which they hold over the assets

It also results into the reduction of capital of the company which is not allowed by section 100 of the Companies Act, 1956 unless certain formalities have been observed, and Court's permission is taken

Dividends may be said to be paid out of capital when they are paid—

(i) out of the proceeds of sales of the fixed assets of the company ,

(ii) out of overstated profits in case of the revenue expenditure being charged to the capital , and

(*iii*) even if the Profit and Loss Account does not show any profit and there had been no undistributed profit with the company

It may be noted that the consequences of payment of dividend out of the capital of the shareholders are serious and the directors will be jointly and severally held liable for it They may be called upon to replace the amount with interest Of course, they will not be held liable if they relied upon *bonafide* valuation by the trusted officials of the company The amounts may be recovered from the shareholders also if they participate in the distribution of dividends knowing that they have been paid out of capital

Let us give briefly some legal decisions on the subject

In *Oxford Benefit Building Society* (1886) and *re Kingston Cotton Mill Co* (1896), it was held that the directors would be personally held liable to make good the amount of dividends if they paid dividends out of capital knowingly

In *Stringer's Case* (1869) and *Rance's Case* (1870) it was held that the directors would not to be held liable if they relied upon the bonafide valuation of the assets of the company which later on proved to be an over-estimate

It was held in *Dovey v Cory* (1910) that the directors can rely upon the trusted officers of a company for the reports and valuation given by them, provided they had no ground for any suspicion.

In *Moxhan v Grant* (1900) it was held that the directors may have a right of indemnity against the members of the company who received the dividends knowingly that the payments were being made out of capital.

Dividends and provision for Depreciation According to Section 205 of the Act a company can declare or pay dividend for any financial year—

(*i*) out of the profits for that year arrived at after providing for depreciation in accordance with prescribed manner, or

(*ii*) out of the profits for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed, or

(*iii*) out of both, or

(*iv*) out of moneys provided by the Central Governments or a State Government for the payment of dividend in pursuance of a guarantee given by the Government

Under Companies (Amendment) Act, 1974, it has been provided that no dividend shall be declared or paid except after the transfer to reserves of the company of such a percentage of profits for that year, not exceeding 10 per cent, as may be prescribed

However, there are the following four exceptions to the above provisions .

(*a*) If the company has not provided for depreciation for any previous year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960, it shall, before declaring or paying dividend for any financial year, provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years

(*b*) If the company has incurred any loss in any previous financial year or years, which falls or fall after the commencement of the Companies (Amendment) Act, 1960, then, the amount of the loss or an amount which is equal to the amount provided for depreciation for that year or those years, whichever is less, shall be set off against the profit of the company for the year for which dividend is proposed to be declared or paid or against the profits for any previous financial year or years, arrived at in both cases after providing for depreciation

(*c*) The Central Government may, if it thinks necessary in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation

(*d*) It shall not be necessary to provide for depreciation as aforesaid where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before the commencement of the Companies (Amendment) Act, 1960

It may be noted that depreciation may be provided in accordance with Sections 205 (2) and 350 of the Companies Act, and Indian Income Tax Act, or rules made thereunder by the Central Government

Section 205 (3) mentions that "No dividend shall be payable except in cash " But there is an exception which permits the capitalisation of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company

Two new Sections, 205A and 205B, have been inserted in the Companies (Amendment) Act, (1974) Section 205 deals with the unpaid dividend and provides that if a dividend has been declared by a company but has not been paid, or a warrant in respect thereof has not been posted, within forty-two days from the date of declaration, to any shareholders entitled to the payment of dividend, the company shall, within seven days from the date of expiry of the said period of forty-two days, transfer the total amount of dividend which remains unpaid or in relation to which no dividend warrant has been posted within the said period of forty-two days, to a special account to be opened by the company in that behalf in any scheduled bank

to be called "Unpaid Dividend Account of Company Limited/ Company (Private) Limited" In case, the whole or any part of any dividend, declared by a company before the commencement of the Companies (Amendment) Act, 1974, remains unpaid at such commencement, the company shall, within a period of six months from such commencement transfer such unpaid amount to the account referred above Any money transferred to the said account remains unpaid for a period of three years from the date of such transfer, shall be transferred by the company to the general revenue account of the Central Government

Under Section 205B, any person claiming to be entitled to any money transferred under the provisions of Section 205A, referred to above, to the general account of the Central Government, may apply to the Central Government for payment of the money claimed , and the Central Government may, if satisfied that such a person is entitled to the whole or any part of the money claimed make an order for the payment to that person of the sum due to him after taking security from him, as it may think fit

KINDS OF DIVIDENDS

Dividends can be 'final' or 'interim' If the dividend is declared at the end of the financial year when its Profit and Loss Accounts are prepared, it is known as 'final dividend' If it is declared in between two annual general meetings of the company and thus declared before the declaration of the final dividends, it is known as 'interim dividend'

INTERIM DIVIDENDS

The Articles of Association of the companies often contain provisions authorising the directors to declare interim dividends Regulation 86 of the Table A of the Companies Act also provides powers to the Board for the declaration of interim dividends if the profits of the company justify such declaration An interim dividend is declared before the declaration of the final dividend at the end of the financial year of the company when its Profit and Loss Accounts are prepared As the directors anticipate the profits in excess, they declare such dividends in between the period of the two annual general meetings of the company when the accounts are not finally ready or audited For the declaration of such dividends there is no need for holding the meeting of the shareholders to obtain their sanction They are declared by the directors

The directors usually call upon the auditors to give their suggestions or device with regard to the declaration of interim dividends The auditor should very carefully study the whole situation and only then give correct advice in this matter He should see that the articles contain provisions permitting the payment of such dividends

He should always advise for the preparation of Interim Accounts, ascertain that there are profits out of which the dividend is going to be legally declared The Interim Accounts for the period, say half year, must be prepared and the profits for the given period should be estimated very carefully It will be better if the profits are calculated on the conservative basis to avoid any problem in future Sometimes it is suggested that there is no need for the preparation of Interim Accounts if the sales and the gross profits for the past several years have been consistent and the current year also does not show any abnormal situation Under such circumstances, the profits for the half year may be estimated on the basis of the percentage of gross profits on turnover for a similar period in the past However, the actual expenses of the period will have to be deducted from such estimated gross profits and due allowance has also to be given for depreciation, bad debts or any contingencies etc In this way the net profit for the period may be estimated and on the basis the interim dividend may be declared It is suggested with a view to avoid the problems of stock-taking and other difficulties in the preparation of the Interim Accounts However, the auditor must examine the whole situation and if he finds that his method would not be appropriate for the estimation of the net profits of the period, he must advise for the preparation of the Interim Accounts to estimate the net profits.

He should safeguard that it is not the existence of large cash balance that has prompted the directors to declare the interim dividends The existence of large cash balance does not necessarily mean the existence of profits also, and the dividends should be declared only when there are profits The concern may have a large cash balance on account of various reasons, *e g* it might have sold its fixed assets, or borrowings might have been resorted to through the issue of debentures or through other sources, or the concern might have resorted to credit purchasing leaving cash balance in hand Even with the existence of large cash balance there may be loss to the concern and, likewise, it may have made a large profit even though the cash balance may be quite small It may be noted that the declaration of interim dividend merely on the basis of large cash balance and without calculation of profits for the period may amount to declaration of dividends out of capital, which is illegal

He should also examine the cash situation of the concern prior to the declaration of interim dividends It would not be a wise step to declare the interim dividend if such declaration results into the depletion of cash resources of the concern to such an extent that its working capital may be drained and it may have to resort to borrowing Hence the auditor should insist upon the estimation of the future requirements of cash If sufficient funds remain after giving due allowance to all these considerations, only then the interim dividends should be declared

The auditor should also insist upon focussing the attention over the general prospects of the concern in future, specially for the

remaining period of the current year in which the interim dividends are being declared It is to be noted that "interim dividend is only a payment on account of the whole dividend for the year and, consequently, if an interim dividend is declared in respect of profits earned during a portion of the year, and during the remainder of the years a loss is made, resulting in a loss on the whole year, the interim dividend will have been paid out of capital" Under such circumstances, the interim dividend might have been declared out of capital which is illegal, as we have seen earlier It would hold the directors as well as the auditors liable for it Therefore, proper attention must be paid to the future prospects of the concern and seasonal fluctuations in the remainder of the year

The auditor should give advice to the directors that the rate of interim dividend should be lower than the rate of final dividend usually declared by the concern It should also be lower than the estimated rate of dividend for the whole year It is necessary with a view to avoid any fluctuation in the market value of the share which is not sound It will cause hardship to some and profits to other shareholders

The auditor should also review the situation in the past and see whether it has been a practice on the part of the concern to declare the interim dividend every year If it is so, he should advise the declaration of the interim dividend in the current year also If usually the concern has been doing so but it does not declare them in the current year, it will affect the credit-worthiness of the concern and the market value of its shares

In short, the auditor must review the whole situation very carefully and see that the declaration of the interim dividend would not be against financial prudence and would not result into the declaration of dividend out of capital But it should be noted that it is no part of his duty to give suggestions in this regard unless called upon to do so by the directors But once called upon to do so he must be careful to look into the whole situation before making any recommendation

FINAL DIVIDENDS

A company, in general, declares dividend at the end of the trading period when the accounts have already been prepared and the divisible profits ascertained in accordance with the provisions of the Articles, if any It is the discretion of the directors to recommend the dividend at the rate at which they think proper They have to pay attention to the amount of reserves to be maintained, the general financial position of the company, future prospects, need for ploughing back etc , before making any recommendation for the declaration of dividends They must keep in mind that as far as possible the dividends should be declared at a steady rate from year to year It is a sound policy to avoid any fluctuation in the rates of dividends from year to year This uniformity would increase the credit-worthi-

ness of the company and stability in the value of the shares A Dividend Equalisation Fund should be maintained for providing dividends in the years when for some reason the company is not able to earn enough profits If it earns a larger amount of profits in a particular year, it would be better to declare the dividend at the usual rate and declare a bonus with extra profits This bonus may be paid in cash or in the form of shares It should be paid in cash only when the company's cash position or liquid position is very sound

After the declaration of dividend, the company must make arrangement for the payment of dividends It must be paid within forty two days after the declaration of the dividend (Section 207) The directors feel difficulty in making such arrangement when they find that the cash resources of the company are quite insufficient But they must make necessary arrangement for it They can approach the bank for an overdraft if they feel that the cash has been locked up in book debts and stocks etc , and can be realised soon But if there is no possibility of realising cash soon and it has been utilised for long-term purposes or spent in purchasing fixed assets etc , it would not be wise to approach the bank for an overdraft Under such circumstances they should issue redeemable debentures It would increase the burden of regular payment of interest on the debentures until they are redeemed, but that can be borne by the extra profits earned from the fixed assets purchased on account of which the cash was locked up In case these alternatives do not suit the company and long term funds are to be raised for this purpose, it may issue bonus shares Of course, this will result into an increase in the amount of share capital and thus will increase the burden for the payment of dividends on this extra share capital This last method would be more practicable when the future prospects of the company are very good

Usually, the companies prepare a Dividend List with the help of which the Dividend Warrants are prepared A Dividend Warrant is a document which gives the shareholders the authority to receive the payment of the dividends to which they are entitled Usually these Dividend Warrants are sent to the shareholders at their addresses As a precautionary measure some companies give a public notice of the declaration of dividends and do not send the Dividend Warrants unless they apply for them It avoids any risk of loss of the Warrants because of the change in address of the shareholders which they could not notify in time

The Dividend Warrants may be payable to its holders in one of the following manners

(i) They may be made payable directly by the company's bank In the case the company will have to open a separate account for each dividend The account may be opened by the dividend number The company will have to draw a cheque from its general account and make payment into the Dividend Account in the bank It should send a cancelled specimen of the Dividend Warrant to the bank It

will also have to issue the Dividend Warrants with the order to the bank to that effect It should carry on periodical checking with the help of the Dividend Pass Book

(*ii*) They may be made payable by issuing a cheque to that effect in the name of each holder of the warrant

(*iii*) Payment may be made in any other manner on the presentation of the Dividend Warrants as the office of the company In this case the company will have to issue the Dividend Warrants with a note that they will be made payable at the office of the company A note to that effect should also be made on the Dividend List

Dividend may be declared 'free of income-tax' or 'less tax' If it is declared free of income-tax, it means that the shareholders will be paid the gross amount of the dividends declared without any deduction by way of income tax On the other hand, if it is declared less tax, it means that the shareholders will receive only the net amount of the dividend after deducting from the gross dividend the amount of income-tax at the prescribed rate ruling at the time of the declaration of dividend In general, the dividends are declared less tax unless it is specifically mentioned otherwise In case of dividends on preference shares, they are always paid less tax unless there is a provision contrary to this in the Articles of the company But it should be noted that the company does not pay the amounts of tax deducted from the gross dividend to the Income Tax authorities Since it has to pay income-tax every year on its net profits, it has not to pay it again at the time of the declaration of dividends By deducting the tax from the gross dividends the company simply recoups from the shareholders a part of the tax already paid by it

Unclaimed Dividends After the declaration of dividends, some of the shareholders do not present the Dividend Warrants to claim the money by way of dividends from the company This credit balance on the Dividend Account in the books of the company represents the unclaimed dividends At the end of the accounting period, it is transferred to 'Unclaimed Dividend Account'. It must appear as a liability on the Balance Sheet under the heading of "Current Liabilities and Provisions"

The articles of the company usually contain a provision for the forfeiture of unclaimed dividends after the lapse of certain specified period In that case the company can forfeit the unclaimed dividends after the lapse of the specified period and credit to the Reserve Fund It should not be credited to the Profit and Loss Account as a matter of financial prudence, though legally it can be so done

In case the Articles do not contain any provision with regard to the forfeiture of unclaimed dividends, the shareholders can claim them at any time before they become time barred It is to be noted that they do not become time-barred until the expiration of six years from the date of the declaration of dividends

The auditor should see that the unclaimed dividends are being

shown in the Balance Sheet of the company till they have been paid or forfeited In case they have been forfeited, he should examine the Directors Minute Book to see that it has been legally done He should also refer to the provisions of the Articles of the company in this regard He should see that they have been transferred to the Reserve Fund or otherwise as required by the Articles He should also see that provisions of Sections 205A 205B, as referred earlier, have been duly observed

Arrears of Dividends on Preference Shares Preference shares may be issued as cumulative which means that holder of such shares can claim the arrears of dividends on such shares But arrears of dividends on cumulative preference shares can be paid only out of profits The company should have sufficient profits in the subsequent years but such dividends should also have been duly declared by the company Until they become payable, they should appear in Balance Sheet as a contingent liability The amount of dividends in arrear and the period for which they are in arrear should also be noted in the Balance Sheet In case the dividends are tax-free it should also be specifically mentioned

Scrip Dividends In general, the dividends must be paid in cash Sometimes the companies, usually the finance companies make payment of dividends in the form of shares and debentures Such dividends are known as Scrip Dividends

The Companies Act, 1956 lays down under Section 205 (3) that "No dividend shall be payable except in cash Provided that nothing in this sub section shall be deemed to prohibit the capitalisation of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company" Before the amendment of this section in 1960, a company could distribute scrip dividends

The companies resort to the capitalisation of profits or reserves in case there is accumulation of huge reserves out of profits which do not represent the liquid assets of the company Such reserves are permanently employed in the business and ultimately take the form of part of the real capital employed The company may decide to distribute it in the form of dividends to the members of the company. It is advisable amongst shareholders since reserves accumulated out of profits maintain their revenue nature But it is not advisable to pay such additional dividends in cash if the reserves have to be distributed Instead, bonus should be paid to the shareholders of the company This payment of bonus can be made in two ways Either the partly paid shares of a company should be taken as fully paid, or fresh fully paid shares known as bonus shares should be issued It results into the capitalisation of profits or reserves since bonus shares thus issued form part or the subscribed capital of the company

AUDITOR'S DUTIES

The auditor has to vouch the payment of the dividends by the company very carefully His duties in this connection are as follows

1 He should refer to the provisions of the Memorandum of Association and the Articles of Association of the company, and see that all those provisions have been duly complied with He should also consult them to ascertain the respective rights of the different types of shares, if any

2 He must see that the various provisions of the Companies Act, 1956 have been duly observed while declaring or making payment of dividends

3 He should check the directors' and the Shareholders' Minute Books carefully to ascertain the rate of dividends declared and that it has been properly recommended by the directors He should also see that the shareholders also passed the resolution to this effect in general meeting of the company

4 He should check the Dividend List with the Register of Members to see that dividends have been correctly calculated

5 He should vouch the payment of dividends to the shareholders with the help of the receipts from the shareholders

6 If the dividends have been paid through the company's bank he should check the Bank Pass Book with the returned and cancelled Dividends Warrants

7 In case the dividends have been paid in kind or Scrip dividends have been paid or bonus shares have been issued, he should refer to the Articles of the company and see that they contain a provision to this effect

8 He should refer to the Dividend Account to ascertain the dividend unclaimed He should see that it has been shown in the Balance Sheet of company until paid back In case it has been forfeited he should refer to the Articles and Directors Minute Book

9 In the absence of the Articles of Association, the auditor should see that the provisions given in Table A of the Act have been duly complied with

10 **The auditor should see that provisions of Companies (Temporary Restriction on Dividends) Ordinance** on July 16, 1974, later converted into Act, are duly observed Under it, maximum distributable profits have been pegged to – (*a*) one third of after tax-profits, or (*b*) an amount required to pay 12 percent dividend on face value of equit shares and preference shares, whichever is less

QUESTIONS

1 Discuss the various kinds of dividends and the provisions of the Companies Act, 1956 regarding them

2 "Dividends cannot be paid out of capital. Explain it and discuss the auditor's duties in this connection

3. Explain the auditor's duties regarding the unclaimed dividends and 'arrears of dividends on preference shares'.

4 When it can be said that the dividends have been paid out of capital? Describe the auditor's duties also in this connection

5 "A company cannot declare dividends without making provisions for depreciation" Explain it and discuss the legal and commercial viewpoints in this connection

6 Do you agree with the statement that "Capital profits may be used for payment of dividends but dividends must not be paid out capital"

7 Describe the various sources from which the dividends can be paid by a company Explain the auditor's duties with regard to payment of dividends

8 Explain the auditor's duties regarding payment of final dividends by a company

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Company Auditor's Report

An auditor has to submit to his client a report on his findings The audit report is one of the most important phases of his duty as through it the client receives tangible evidence of the work done and results of the audit Utmost care must be taken in compilation, drafting and rendition of report materials He has to summarise in clear words the scope of the work performed or not performed, the results of what he did and his opinion as to the financial state of affairs of the concern

A report has been defined by Lancaster as 'a statement of collected and considered facts, so drawn up as to give clear and concise information of persons who are not already in possession of the full facts of the subject matter of the report "[1]

In the word of J C Ray, "The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed When an overall opinion cannot be expressed, the reasons therefore should be stated In all cases where auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking "[2]

A report is nothing but a statement of facts The facts are those which have not only been collected but also *considered* at the same time The various informations set forth in it should be written in *clear* and *concise* words There should be no room for any ambiguity Further, the facts and informations which have been incorporated therein are to be conveyed to those persons who do not possess full facts They come into the possession of an auditor during the course of audit He must convey to his clients the material facts known to him and which he feels must come to their notice

Another point in this connection is that an auditor has to give expression of *his opinion* in the report According to Webster "a brief which is stronger than mere impression but less strong than positive knowledge is an opinion " But the general opinion differs from professional opinion "A professional opinion implies that the

1 *Principles and Practi of Auditing*, p. 347.

2 *Independent Auditing Standards*, p. 466

judgment of an expert has been examined by the expert to provide reasonable grounds for the expression of such an opinion When applied to auditing, opinion refers to the auditor's belief as to whether or not the financial statements 'present fairly' Since the auditor's opinion is a professional one, it must be based on examination of sufficient evidence to support the opinion On the other hand, the fact that the auditor's opinion is something less than positive knowledge cannot be over-emphasised "[1]

An auditor's report is essential for the shareholders of a company as they do not possess full facts about it It is the management who are in possession of full facts about the company's affairs and they may present a wrong picture in their own interest An independent opinion about the financial affairs of the company is thus essential and the auditor's report serves that purpose

A distinction between the auditor's report and auditor's certificate should be clearly understood An auditor is required to give certificates verifying the correctness of date submitted to the various government and non-government agencies For instance, the owners of magazines and other periodical publications have to get their circulation figures verified before they can get their quota of newsprint In case of such certificates the auditor verifies certain exact facts He certifies the precision and accuracy of the data But in case of a report, he simply expresses his opinion and does not certify the exactness of accounting a financial data

Extent of Reliability An auditor's report is a tangible proof of the financial state of affairs of the company and merely indicates how the interests of the shareholders are being looked after by the management It may be noted that the auditor is not expected to guarantee the accuracy of the books of account Neither he is an insurer nor a guarantor If he gives a clean report, he does not guarantee that every detail of the books of account of the company is completely accurate Ingeniously laid down frauds etc perpetrated for the trusted employees of the company may remain undetected even the books of account have been subjected to audit He should thus be considered competent enough to unearth such frauds etc Justice Lopes pointed out in *re Kingston Cotton Mill case* (1896), "auditors must not be held liable for not tracking out ingenious and carefully laid scheme of fraud, when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors So to hold would make the position of an auditor intolerable "

A statement issued in this connection by the Institute of Chartered Accountants in England and Wales in 1961 is worth noting It says "Material irregularities will normally be brought to light by sound audit procedures but there is nothing in the Companies Act which specifically places a duty upon auditors to search for them or

1 Robert L Grinaker, "The Accountant's responsibility in expressing an opinion", in J C Ray's *Independent Auditing Standards*, p 468

to examine the books and accounts with the object of discovering whether there have been defalcations or other irregularities by directors or employees of the company "

In one of the official statements issued by the Committee on Auditing Procedure of the AICPA (USA), this position is well confirmed It states

"In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist, financial statements may be misstated as the result of defalcations and other similar irregularities, deliberate misrepresentation by management, or both He recognises that any fraud, if sufficiently material, may affect his opinion on the fairness of the presentation of the financial statements, and his examination made in accordance with generally accepted auditing standards, gives a consideration to this possibility However, the ordinary examination incident to the expression of opinion on financial statements, is not primarily or specifically designed and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to ensure its discovery The responsibility of the independent auditors for failure to detect fraud (which responsibility differs as to clients and other) arises only when such failure clearly results from non compliance with generally accepted auditing standards

"If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive Even then he could not give assurance that all types of frauds had been detected or that none existed because items such as unrecorded transactions, forgeries and conclusive fraud would not necessarily be uncovered

"The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negligence on his part He is not insurer or guarantor and, if his examination was made with due professional skill and care, in accordance with generally accepted auditing standards, he has fulfilled all of the obligations implicit in his undertaking "

It would thus be clear as to what extent the auditor's report should be relied upon But it should not be taken to undervalue the importance of the report which serves a very useful purpose, as has been emphasised earlier

Contents of the Report The auditor, should as far as possible, follow the provisions of the Companies Act, 1956 relating to the contents of the Report These are enumerated below

(1) An auditor should state in his report whether—

(*a*) in his opinion and to the best of his information and according to the explanations given to him, the accounts

give the information required by the Act,

(*b*) the Balance Sheet and the Profit and Loss Account give a true and fair view of the state of company's affairs as at the end of its financial year,

(*c*) he has obtained all the informations and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit,

(*d*) in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for purposes of his audit have been received from branches not visited by him,

(*e*) the report on the accounts of any branch office audited under Section 228 by a person other than the company's auditor has been forwarded to him and how he has dealt with it in preparing the report,

(*f*) the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and returns,

(*g*) if any or the above matters requires qualification or a negative answer, the reasons for the same

(2) The auditor's report shall also include a statement on such matters as specified by the Central Government under clause 4A of Section 227 of the Companies (Amendment) Act, 1965 According to this Section, the Central Government may, by general or special order, direct that, in case of such class or description of companies as may be specified in the order, the auditor's report shall also include a statement on specified matters With this provision the Central Government has assumed powers to bring to the knowledge of the members any point or fact which it may feel necessary and in the interest of the members

(3) The auditor's report shall not state that those accounts have not been properly drawn up on the ground merely that the company has not disclosed certain matters if—

(*a*) those matters are such as the company is not required to disclose by virtue of any provisions contained in this or any other Act, and

(*b*) those provisions are specified in the Balance Sheet and Profit and Loss Account of the company.

(4) He should see that the Profit and Loss Account is annexed to the Balance Sheet and the auditor's report (including the auditor's separate, special or supplementary reports, if any) shall be attached thereto (Section 216) It should be noted that the documents annexed to a company's accounts, wherever it is required in the Act, do not include the Board's report, the auditor's report or any

document attached to those accounts (Section 222) In case some informations are given in the Board's report instead of in the accounts, the auditor shall report thereon only in so far as it gives the said informations

It should be further noted that under Section 211, dealing with the form of Balance Sheet and Profit and Loss Account, the reference to a Balance Sheet and Profit and Loss Account shall include any notes thereon or documents annexed thereto giving informations as required

Auditor's Duties Under Section 227 (2) of the Companies Act, 1956 the auditor of a company is required to make a report to the members of the company on—

(*i*) the accounts examined by him,

(*ii*) every Balance Sheet and Profit and Loss Account, and

(*iii*) every other document declared by the Act to be part of or annexed to the Balance Sheet or Profit and Loss Account, which are laid before the company in general meeting during the tenure of his office

It is, thus, a part of auditor's legal duties to submit a report to the members of the company on the accounts prepared by the management of the company

An auditor should be careful about the words and phrases used in the report. He should pay attention to the following points

(*i*) He has to form his *opinion* about the financial state of affairs of the company and report it accordingly It may be noted that it is not the opinion of the management which has to be reported to the shareholders.

(*ii*) He has to form opinion *according to the best of his information and explanations given to him* It implies that he would not be held legally responsible if he acted on the faith of the information and explanations given to him by the management which were in fact not correct But he should have acted with reasonable care and skill and no suspicion should arise with regard to the correctness of the information and explanations given to him during the course of his audit On the other hand, it is likely that the Balance Sheet may be correct in accordance with the books of account but the auditor may be having knowledge of certain facts which indicate that the books themselves are incorrect He must inform this fact accordingly, otherwise he will be failing in his duty If the explanations which he sought were not given to him, he must qualify his reports with such remark

(*iii*) He has to see that the Balance Sheet and Profit and Loss Account *are in agreement with the books of account and returns* It has, however, limited his liability to some extent It implies that the auditor would not be held responsible for those transactions which were not recorded in the books of account at all Of course, he

must apply reasonable care and skill in the conduct of his audit He would be however, held responsible for the omitted transactions not recorded in the books of account if it would have been possible for him to discover them by exercising reasonable care and skill But it does not mean that he has to compare the Balance Sheet with the books of account with a view to ascertain that it agrees therewith He must exercise reasonable care and skill to ascertain that the Balance Sheet reflects the true and fair financial state of affairs of the company

(iv) He must see that the accounts given the *informations required by the Act* Not only this, those informations must be given in the manner required by the Act, which means that the provisions of Schedule VI of the Act must be duly complied with

(v) He has to report that the Balance Sheet and Profit and Loss Account give *'true and fair' view of the state of affairs of the concern* This phrase has wide implications and has been substituted in place of the phrase 'true and correct' as was given in Section 145 of the Companies Act, 1913 This charge has been brought about on the lines of the English Companies Act, 1948 The term 'fairness' has got wide implications In the words of Stettler, 'Fairness is a pervasive concept which extends to every phase of the financial statements Thus the auditor's assertion as to the fairness of the statement covers such matters as the adequacy of the provisions made therein for depreciation, bad debts, and income taxes , the propriety with which items have been classified within the financial statements , and the appropriateness of the descriptions of the various amounts shown in the statements Stated in more general terms, in order for statements to present fairly the financial position and results of operation of a business, the statement must be factual, they must fully disclose all essential information, and they must not be misleading to the average reader "[1] It has extended the liability of an auditor of the company to a great extent It has the following consequences

(a) He has not simply to see that the final accounts of the company are in agreement with its books of account In other words, it is *not the arithmetical accuracy of the books alone* which is his concern He has to see as to how far the accounts exhibit or represent the financial state of affairs of the company The emphasis has to be shifted from the correctness of accounts to the presentation of accounts

(b) He has not merely to staisfy himself with the transaction recorded in the books, but he will have to go *behind the transactions recorded in the books* with a view to ascertain whether the true effects of the transactions are reflected in the final accounts. It is only by going behind the transactions recorded that he may be sure that the accounts present the financial picture which is fair to the shareholders.

1. Howard Stettler, *Auditing Principles*, p. 11.

(*c*) *Creation of secret reserves is prohibited* since its creation may be correct but not fair to the shareholders

(*d*) He must see carefully that the *assets are neither overvalued nor undervalued*, the liabilities have been shown in the Balance Sheet with correct value, and provisions for depreciation or reserves etc, have been adequately made In short, he must see that all the assets and liabilities are shown in the Balance Sheet in such a manner that it is not misleading at all

(*e*) He will have also to see carefully "*the accounts are true and fair not only in the sense of what they disclose but also in the sense of what they conceal or omit*" For example, certain items may be omitted or not disclosed, and this may render the accounts to be untrue or unfair Thus an auditor will have to see those items also which have not been disclosed but which ought to have been disclosed so that the amount may exhibit the true and fair view of the state of affairs of the company

(*f*) He has to see that *proper distinction has been made between revenue and capital* expenditure as well as the normal and abnormal receipts or expenditures Abnormal receipts or expenditures should be shown separately so as to distinguish them from the normal receipts or expenditures

(*vi*) An auditor has to satisfy himself and report that the company has complied with the requirements of the Act with regard to *maintenance of the books and other records* In case this company has a branch also, he will have to see that proper and regular returns have been received from the branch office, its accounts have been duly audited by a qualified auditor appointed by the company in its general meeting The Act, after amendment, also requires that the company auditor should mention in his report how he has dealt with the branch auditor's report while preparing his report It is required when the accounts of branch office of the company have been audited by a person other than the company's auditor

ADDITIONAL MATTERS IN THE AUDIT REPORT UNDER MANUFACTURING AND OTHER COMPANIES (AUDITOR'S REPORT) ORDER, 1975

Section 227 (4-A) of the Companies Act, 1956 empowers the Central Government to direct, by a general or special order, that in the case of specified companies the auditor's report shall include a statement on such matters as may be specified in such an order Under these provisions, the Central Government has issued the "Manufacturing and Other Companies (Auditor's Report) Order 1975" The Order came into effect from January 1, 1976

This Order is applicable to the companies engaged in one of more of the following activities

(1) Manufacturing, mining or processing,

(2) supplying and rendering services ,
(3) trading , and
(4) the business of financing, investment, chit fund, *nidhi*, or mutual benefit societies

It may be noted that the Order is not applicable for the banks

The Order requires that the auditor will have to include certain specified matters, described below, while giving report on the accounts of the examined by him and to which this Order applies The matters specified are different in case of above-mentioned different companies.

(1) *Manufacturing, Mining or Processing Companies*

In case of manufacturing, mining or processing companies, the audit report should include a statement on the following matters

(*i*) Whether the company is maintaining proper records to show full particulars, including quantitative details and situation of fixed assets , whether the fixed assets have been physically verified by the management, and if any serious discrepancies were noticed on such verification, whether the same have been properly dealt with in the books of account

(*ii*) In case, any of the fixed assets have been revalued during the year, the basis of revaluation should be indicated

(*iii*) It should be examined and reported whether physical verification has been conducted by the management at reasonable interval or periods in respect of finished goods, spare parts and raw materials, and, if any significant discrepancies have been noticed on such verification as compared to book records, whether the same have been properly dealt with in the books of accounts It is to be seen whether the auditor is satisfied that the valuation of these stocks is fair and proper in accordance with the normally accepted accounting principles and is on the same basis as in the earlier years If there is any deviation in the basis of valuation, the effect of such deviation, if material, is to be duly reported

(*iv*) In case the company has taken any loans, secured or unsecured, from companies or firms or other parties listed in the register maintained under Section 301 and 370 (1-C) of the Companies Act, 1956, it has to be reported whether the rate of interest and the terms and conditions of such loans are *prima facie* prejudicial to the interest of the company.

(*v*) It has to be stated whether the parties to whom the loans or advances in the nature of loans have been given by the company are repaying the principal amount as stipulated and are also regular in payment of the interest and, if not, whether the reasonable steps have been taken by the company for recovery of principal and the interest

(*vi*) The statement shall include whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business for the purchase of stores, raw

material, including components, plant and machinery, equipment and other assets

(*vii*) In case, any stores, raw materials or components exceeding Rs 10 000 in value for each type thereof are purchased during the year from subsidiaries, firms or companies or other parties in which the directors are interested, whether the prices paid for such items are reasonable as compared to prices of similar items supplied by other parties

(*viii*) It has to be examined and stated whether any unserviceable or damaged stores and raw materials are determined and whether provisions for the loss, if any, has been made in the accounts

(*ix*) In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India, and the provisions of Section 58 A of the Companies Act, 1956, and the rules framed thereunder, wherever applicable, have been complied with

(*x*) Whether the company is maintaining reasonable records for the sale and disposal of realisable by-products and scraps where applicable and significant

(*xi*) In case the paid-up capital of the company at the commencement of the financial year concerned exceeds Rs 25 lakhs, it has to be stated whether the company has an internal audit system commensurate with its size and nature of its business

(*xii*) Whether the maintenance of cost records has been prescribed by the Central Government under Section 209 (1) (d) of Companies Act, 1956, whether such accounts and records have been maintained

(*xiii*) Whether the company is regular in depositing the provident fund dues with the appropriate authorities and, if not, extent of arrears of provident fund dues shall be indicated by the auditor

(2) *Companies supplying and rendering services*

For the companies supplying or rendering services, or service companies, the following additional matters have to be reported

(*i*) All the matters specified under (1) above to the extent to which they are applicable

(*ii*) Whether the company has a reasonable system of recording receipts, issues and consumption of materials and stores commensurate with its size and nature of business and whether such system provides for a reasonable allocation of the materials and man-hours consumed to the relative jobs

(*iii*) Whether there is a reasonable system of authorisation at proper levels with necessary control on the issue of stores and allocation of stores and labour to jobs and whether there is any system of internal control commensurate with the size of the company and the nature of its business

(3) *Trading Company*

In case of a trading company, the following additional matters have to be stated in the auditor's report

(*i*) All the matters under (1) mentioned above, to the extent to which they are applicable

(*ii*) Whether the damaged goods have been determined and if the value of such goods is significant, and whether the provisions have been made for the loss

(4) *Finance, Chit Fund, Nidhi, or Mutual Benefits Companies*

In case of companies engaged in the business of finance, chit fund, *nidhi* or mutual benefit, the following additional matters have to be reported

(*i*) All the matters specified under (1) mentioned above, to the extent to which they are applicable

(*ii*) Whether adequate documents and records are maintained in a case where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other similar activities

(*iii*) Whether the provisions of any special statute applicable to chit fund, *nidhi*, or mutual benefits society have been duly complied with.

(*iv*) If the company is dealing or trading in shares, securities, debentures and other investments whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein Also whether the shares, securities debentures and other investments have been held by the company in its own name except to the extent of the exemption, if any granted under Section 49 of the Companies Act, 1956

It may be noted that the Order stipulates that in case auditor gives unfavourable or qualified answers to any of the questions on which a statement is required to be included in his report, the reasons for such answers should also be stated by him in clear words In case, he is unable to express any opinion in answer to a particular question, his report, would also indicate this fact He should also mention the reasons why it is not possible for him to give an answer to the particular question.

It may also be pointed out that if an auditor gives qualified answer to such questions that would not necessarily make his opinion on the truth and fairness also qualified, unless, of course, the qualified statement is such that it affects working results or the financial condition as disclosed by the profits and loss account and the balance sheet

MANUFACTURING AND OTHER COMPANIES (AUDITOR'S REPORT) ORDER, 1975, AND SOCIAL AUDIT

After the issue of the Manufacturing and Other Companies (Auditor's Report) Order, 1975, there has been a controversy whether this is a social audit ? It was thought that it has extended the scope of audit considerably and it has now, made the auditor more responsive to the needs of the society and as such this has been taken to be a social audit But this is not wholly true In fact, the social audit has much wider implications and that "encompasses an assessment of what a company contributes to the society and what it takes away from it" However, it has certainly resulted in different 'orientation' to company audit

It gave rise to such a controversy on account of the fact that when this Order was promulgated it was stated that it was introduceing "regulatory social audit" The object of such Order was also stated to be "ensure that the social objective of company audit by chartered accountants is achieved in a greater measure, considering the basic fact that under modern conditions, companies have to subserve public interest rather than purely private gain of the investors " Thus, it would help in introducing social audit to some extent but to call it social audit would be a bit exaggeration We may say that it is a step towards that In fact, the chartered accountants have to read the writings on the wall and should see that the public interest is also to be safeguarded, as much as possible However, it would take a long way to undertake social audit, specially in a country like India, where the auditors have yet to be conscious of this fact

It is notable that some of the obligations of the auditors, as introduced in the Order, have already been assumed by many firms of auditors With the passage of time, the auditors have started undertaking more careful examination of the accounts rather than simply undertake what is known as "verificatory audit" With the growth of large number of Central Government and State Government undertakings in the country, the auditor is becoming conscious of this fact and is changing their attitude accordingly

It has also been pointed out that "Some of the additional matters on which the auditor has to make a statement in his report under this Order represent merely a statutory recognition of what were already recognised as standard "auditing practices " It has been further pointed out that the ' auditing procedure as discussed in the *Statement on Auditing Practices* issued by the Institute of Chartered Accountant of India, is more or less similar regarding stocks and fixed assets to what is implied in this Order Similarly, matters relating to the verification of certain aspects of internal control do not require a substantially new procedure of auditing "

Disclosure of Extraordinary Events Occurring after the Balance Sheet date If an auditor gathers some information about exceptional gains or losses or other unusual *event occurring after the date of Balance Sheet* but before submitting the report, he should try to

disclose them in his report But the events should be "of sufficient importance to cause the reader of the statements to place a different interpretation upon the company's financial condition"[1] For instance, the entire plant may be destroyed by fire, or the bankruptcy of a debtor may be declared after the Balance Sheet date For once he may ignore to disclose any gain but he should not fail to disclose a major loss occurring subsequently to the Balance Sheet date

It may be noted that the auditor is not expected to know about all the significant events after the Balance Sheet date as he is not required to examine records subsequent to it He cannot, therefore, be held responsible if he does not disclose such facts But he may be held responsible if he discloses gains after the closing date, while ignoring losses, both having bearing on the concern's financial position

General Considerations for Drafting the Report The auditor should keep in mind the following points before drafting a report of a company audit

(*i*) He must address to the members of the company in his report It is the shareholders who are the real proprietors of the company In no case he should address it to the Managing Director or Manager etc In case of Special Audit of the company by the Central Government under provisions of Section 233A of the Companies Act, 1956, it should be addressed to the Government

(*ii*) The report should be dated. It will establish the termination of auditor's responsibility for the events occurring subsequent to the Balance Sheet date

(*iii*) The report must be drawn in such a manner as to comply with the requirement of the Companies Act, 1956, subject, however, to any qualification the auditor may like to disclose

(*iv*) The report must be clear worded, specific, complete and courteous. It should be unambiguous and precise Any vagueness in it may hold an auditor judicialy liable It should be so clearly written that anyone who has an occasion to read it may be able to know exactly what he wants to convey The auditor should not try to give in his report the "means of information", instead, the "information" itself should be clearly given in respect of the company's financial position[2] He should not offer suggestions unless asked for

(*v*) It must disclose the facts which he ought to disclose to the members of the company, and at no cost should he be led away by the pressures of the management

(*vi*) The report should be drafted in the office of the auditor and not that of the company In case it is drafted in the company's office, he should do it in a private and separate office in the premises

1 Walter B Meigs, *Principles of Auditing*, p 705-6

2 Lindley J, *In re London General Bank* 1895

(*vii*) He should take care to keep all the thoroughly revised notes and working papers before him while drafting the report so that he may consult them easily

(*viii*) The report should bear the manual signature of the auditor He should add C A below it

(*ix*) He should take care to render the report as soon as possible upon the close of audit as at the time he has a clear picture in his mind Any delay in the preparation may tend to dim his memory and consequently may have adverse effects upon the report

TYPES OF REPORTS

A report may be short or long Earlier the report used to be very short and merely contained the words 'Audited and found correct" The auditor's report of the 19th century was so little a report in the popular sense of the term that, by common consent, it was almost invariably described as "certificate"[1] But it is incorrect and misleading now to call a report as a "certificate" A certificate is a statement of ascertained facts only The term "certificate' conveyed to many people the idea that the auditor was issuing a guarantee of absolute correctness or the financial statements But it should be clear that an auditor is never in a position to guarantee the 'correctness' of financial statements Therefore, the term 'certificate should not be used in place of report'

A long form report is given by the auditor when he wants to give his comments or suggestions also with regard to certain matters The report may be in the form of a letter or a mere statement It may be *clean* or *qualified*

Clean or Unqualified Report The auditor gives a clean report when he is completely satisfied that there is nothing objectionable in the books of account and the Balance Sheet and the Profit and Loss Accounts exhibit the true and fair view of the state of the financial affairs and earnings of the concern He gives his opinion without any reservations

In India, most of the audit reports, submitted by the auditors, are clean or qualified They simply give statutory affirmations without any objection or reservation Such practice is probably due to the fact that the management agree to make the modification in the accounts, as desired by the auditors before the report is submitted

The report may be given in the form given below

To

The Shareholders of ABC Limited

We have audited the annexed Balance Sheet of the ABC Limited as at and also the annexed Profit and Loss Account of the

1 Dicksee, *Auditing*, p. 317

Company for the year ended on that date, and we report as follows

1. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit

2. In our opinion, proper books of account as required by law have been kept by the Company so far as appears from our examination of the books and proper returns adequate for the purpose of our audit have been received from branches not visited by us

3 The accounts of branch office have been audited under Section 228 of the Act by The report on the said accounts which has been forwarded to us has been dealt with by us, in the manner we have considered necessary, while preparing this report

The accounts of branch office have not been audited as required by Section 228 (1) of the Act as the said branch office is exempted from the requirements of Section 228 by virtue of Rule (3)/(4) of the Company (Branch Audit Exemption) Rules, 1961

4 The Balance Sheet and Profit and Loss Account dealt with by the Report are in agreement with the books of account

5. In our opinion, and to the best of our information and according to the explanations given to us, the said accounts read with the notes thereon, give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view :—

(a) in the case of the Balance Sheet of the state of the affairs of the company as at , and

(b) in the case of the Profit and Loss Account, of that profit of the Company for the year ended on that date

For X Y & Co
Dated . *Chartered Accountants*
Partner

(It is to be noted that words "and proper returns Rules 1961" have to be used only when appropriate)

Qualified Report Sometimes the auditor comes across certain objectionable matter recorded in the accounts of the company.

He finds that the Balance Sheet of the company does exhibit the true and fair view of the financial state of affairs of the concern and at the same time the Profit and Loss Account does not give a true and fair view of the profits or losses of the year under audit Under such circumstances, the auditor should request the management to make the desired changes , but if they do not concede to his request, he must qualify his report accordingly He should also state the reasons for the qualifications mentioned in his report

Reasons Walter B Meigs[1] has cited certain reasons which may prevent the issuance of an unqualified report as follows

1 The examination may not have been made in accordance with generally accepted auditing standards

(*a*) The client may place restrictions on the scope of auditor's examinations as for example, not permitting the confirmation of accounts receivable, not taking a physical inventory, or not permitting the auditor to visit a distant branch location where an important portion of the company's assets are located

(*b*) For reasons beyond the control of the client or the auditor, it may not have been possible to perform certain necessary auditing procedures A common example previously discussed is the difficulty or impossibility of confirming accounts receivable from the Government Inventories afford another example In a first audit if inventory records and internal controls are very poor, there may be no way to verify the beginning inventory , consequently, the cost of sales and net income for the year cannot be satisfactorily verified Another example is that of the company whose records have been partially destroyed by fire or flood

(*c*) Internal control may be so seriously inadequate that a satisfactory examination cannot be performed within reasonable time limits

(*d*) The financial statements may have been prepared from the books without audit The independent public accountant is sometimes requested to prepare financial statements for internal use or for presentation to a bank without making any effort at verification A slight variation when the auditor is authorised to make only a limited examination of specified accounts such as cash

2 The financial statements may not have been prepared in accordance with generally accepted accounting principles when the auditor finds that assets have been improperly valued, that liabilities have been omitted, or that other variations of generally accepted accounting principles exist, his first reaction will be to attempt to persuade management to revise the statements In most cases,

1 *Principles of Auditing*, pp 699-700

management will agree, and the deficiencies will be remedied, occasionally, however, management will not agree to the changes considered necessary by the auditor, and consequently an unqualified report cannot be issued

3 Accounting principles may not have been applied consistently as compared with the preceding year An unqualified audit report cannot be issued if the company has changed its method of computing depreciation or that made other material changes in the application of accounting principles as compared with the preceding year

4 The financial statements may not present fairly the client's financial condition and operating results Fairness in financial statements often hinges on the issue of what constitutes full disclosure Assume, for example, that pending legislation indicated that a certain type of business, such as the operation of a race track, may soon be outlawed Disclosure of this threat to continued existence of the business is essential to a fair presentation A similar contingency requiring disclosure is the existence of the claims in the process of litigation Companies working on Government contracts sometimes face the prospect of having to make substantial refunds of excessive profits when the contracts are re-negotiated. The statements would not fairly present financial condition and operating results if the possibility of a refund were not disclosed

Some other examples of the grounds on which an auditor may qualify his report are given on page 292

(i) Insufficient provisions for the depreciations on the fixed assets might have been made.

(ii) The provision for the Bad and Doubtful Debts may not be adequate

(iii) The valuation of the various assets of the company might not have been made correctly They might have been overvalued or undervalued

(iv) Proper explanations sought by auditor might not have been available to him

(v) Some provision of the Companies Act, 1956 might not have been followed by the company

(vi) Secret reserves might have been created

While an auditor has some reasons to qualify his report some times he is put in a difficult position as he is persuaded to avoid or soften it by the management of the company. They take the plea that it would be detrimental even to the interest of the members of company. But the auditor should not be led away by the persuasion and if he believes that the facts must be brought to the notice of the shareholders, he must not deter from his duty and must report the matter to the shareholders through his report He should keep in his mind that he is there to safeguard the interests of the shareholders and should not act in a manner which may prejudice such interests

He should, however, avoid use of any vague expression when qualifying the report with certain remarks He must specify in his report on what points he is not satisfied or what legal provisions have not been complied with Precise wording of the remarks with which he is qualifying the report is very essential He should be able to distinguish between the 'information' and the 'means of information' He should try to give the information itself and not the means of information It was well emphasised in the case of London and General Bank (1895) In this case the auditor qualified his report with the word, "The value of the assets as shown on the balance sheet is dependent upon realisation " Lindly L J, said

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them or some of them to ask for more. Information and means of information are by no means equivalent terms An auditor who gives shareholders the means of information instead of information in respect of a company's financial position, does so at his peril, and runs the serious risk of being held judicially to have failed to discharge his duty "

In other case, Royal Mail Steam Packet Company (1931), the auditor had insisted upon the words "Adjustment of taxation reserves" being included in the wording describing the profits of year The learned Judge had referred to these words as "those mystic words which are said to be so clear but which may or may not be clear" Thus the auditor has to pay due attention to the choice of words being used for qualifying his report.

Specimen. We give below the example of a qualified report —

To

The Shareholders of ABC Limited

I have audited at annexed Balance Sheet of the ABC Ltd, as at and also the annexed Profit and Loss Account of the Company for the year ended on that date, and report that—

1 I have obtained all the information and explanation which to the best of my knowledge and belief were necessary for the purpose of my audit

2 In my opinion, proper books of account as required by law have been kept by the Company so far as appears from my examination of the books

3 The Balance Sheet and Profit and Loss Account dealt with by report are in agreement with the books of account.

4 Subject to the qualifications given below, in

my opinion and to the best of my information and according to the explanations given to me the Accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view —

(*a*) in the case of the Balance Sheet of the state of the affairs of the Company as at , and

(*b*) in the case of the Profit and Loss Account of the profit of the Company for the year ended on that date —

(*i*) The provision for the depreciation on Machinery is insufficient

(*ii*) The Stock-in-trade has been valued at market price, which is higher than the cost by Rs

(*iii*) No provision has been made for the Doubtful Debts in face of the fact that some of the debts are quite old and time-barred

For *X Y & Co*
Dated *Chartered Accountants*
Partner

Signature. It has been specifically provided by the Act that the company auditor *must sign* the report to be submitted Provision for this is contained in Section 229 which runs as follows

"only the person appointed as auditor of the company, or where a firm is so appointed in pursuance of the proviso to sub-section (1) of Section 226, only a partner in the firm practising in India, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated "

Earlier, the practice of the auditors was simply to give the name of the firm of the Chartered Accountants without signing it It was given as below

X Y & Co.
Chartered Accountants

But in 1972, the Company Law advised that the partner of the firm must sign in his own hand for and on behalf of the firm appointed for audit. He should sign in the following manner

For *X Y & Co.*
Chartered Accountants
(Name of the member)
Partner

Rendering of Report It is to be noted that the auditor's report must be read before the company in its general meeting and shall be open to inspection by any member of the company, as has been provided under Section 230

It is no part of an auditor's duty, however, to see that the report has been read in the general meeting of the company He has nothing to do whether a copy of the report has been sent to the members of the company or not He is also not required to see whether the members of the company have been allowed inspection of the report or not In *re Allen Craig & Co*, (*London*) *Ltd* (1934), it was held that the duty of the auditors, after having affixed their signature to the report annexed to the Balance Sheet, is confined to forwarding that report to the secretary of the company leaving the secretary or the directors to convene the general meeting and send the Balance Sheet and report to the members entitled to receive it It is no part of the duty of the auditors to send a copy of their report to each members individually

A firm of auditors is required to send information to the Registrar of Companies concerned about the reports or any other document which he signs This is in accordance with the direction of the Council of the Institute of Chartered Accountants of India which it has given in exercise of the powers conferred by clause (3) of Part III of the First Schedule to the Chartered Accountants Act, 1949 It has directed that in all cases where a firm of Chartered Accountants is appointed as auditors of a company under Section 226 of the Companies Act, 1956, the member or partner of the firm, as the case may be, who signs the auditor's report on the accounts of the company or any other documents of the company required by the Companies Act, 1956, to be signed or authenticated by the auditor, should, at the time he affixes his signature or within a reasonable time thereafter, write to the Registrar of Companies concerned, certifying the fact of his having signed the auditor's report or other documents of the company, and for the year, to be specified by him in the letter.

QUESTIONS

1 What do you understand by the auditor's report ? Explain its kinds

2 Explain the provisions of Companies Act, 1956 regarding the content of the auditor's report

3 Explain the auditor's duties as provided under section 227 of the Companies Act, 1956

4 What is a clean report ? Give a specimen of a clean report of the auditor

5 What is a qualified report ? Give a specimen of the qualified report of the auditor.

6 Explain briefly the additional mattter to be given in the auditor's report under the Manufacturing and other Companies (Auditor's Report) Order, 1975

7 Does the provisions of the Manufacturing and other Companies (Auditor's Report) Order amount to social audit ? Explain

8 Describe the general considerations which an auditor has to keep in mind while drafting his report

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Liability of Auditors

An auditor holds position of great responsibility and has to perform certain duties, statutory or otherwise, allotted to him In performance of his duties he has to exercise reasonable care and skill His client expects him to follow the generally accepted audit standards obtaining at a particular time and he may be held liable in case he does not act with reasonable care and skill required from him in the particular circumstances (In other words, if his client suffers any loss due to his negligence or breach of trust or duty and the errors or frauds remain undetected, he would be held liable for the same and may be called upon to pay the damages suffered by the client on account of his negligence or breach of duty. However, the extent of an auditor's liability cannot be easily laid down It is a very difficult and complex question It has not been clearly laid down either in the satutes or in the legal cases decided on the subject It has been rightly observed by De Paula that "The subject of the exact legal position of auditors is one of considerable complexity and difficulty "[1]

The *liability of an honorary auditor* is the same as that of a paid auditor He cannot be exempted from his liabilities simply because he did not accept any remuneration for conducting his audit work He cannot also take the plea that since the work is without the support of any consideration, therefore, it is void If an auditor has conducted the audit and has submitted his report accordingly, he will be held liable for any damage caused to the client due to negligence on his part or breach of duty by him irrespective of the fact whether he accepted any remuneration for the job or not

The entire problem regarding the auditor's liabilities can be studied under the following broad heads

1. Civil Liability
   (*a*) Liability for negligence , and
   (*b*) Liability for misfeasance
2. Criminal liability
3. Contractual Liability

1. *Op. cit*, p. 210

4 Statutory Liability
   (*a*) Under Companies Act, 1956 ,
   (*b*) Under Chartered Accountants Act, 1949 ,
   (*c*) Under other Acts ,
5 Liability towards Third Parties
6 Liability for Unlawful Acts of the Client
7 Liability to the Article Clerks

1 CIVIL LIABILITY

The civil liability of an auditor can be for (*a*) negligence or (*b*) misfeasance In these cases he may be called upon to pay damages as decided by the Court

(a) Liability for Negligence An auditor is appointed to perform certain duties To the extent of his duties as an audi or, he acts as an agent of his client In this capacity he must exercise reasonable care and skill to perform his duties for which he is employed If he acts negligently on account of which the client is made to suffer loss, the auditor may be held liable and may be called upon to make good the damages which the client suffered due to this negligence In the words of Spicer and Pegler "This liability springs from the general principle of law that where a person is under a legal duty to take care, whether imposed by specific contract or otherwise, the failure to exercise a reasonable standard to care will make that person responsible for any resultant damage or loss *to those to whom* the duty is owned "[1]

An auditor can be held liable if the following conditions are fulfilled (*i*) There should be sufficient ground for holding him liable for negligence A general charge will not be enough and the specific matter in respect of which he failed must be indicated (*ii*) It must also be proved that the client suffered a loss on account of this negligence The auditor cannot be held liable if there is loss to the client without his negligence or there has been negligence of auditor but it does not result into a loss to the client At the same time, it must be proved that the auditor acted negligently, *i e*, he did not exercise reasonable care and skill in the performance of his duties What is reasonable care and skill should be determined on the basis of particular circumstances of each case It should be largely determined by a comparison with the standard which the members in this profession generally observe It may be noted that the auditor does not act as an insurer and does not guarantee the accuracy of the books of account [2]

It may also be pointed out that an auditor is "a watch dog but not a blood hound," as stated by Lord Justice Lopes in *The King-*

1 *Op cit*, p 447
2 In *re London & General Bank* (1895)

ston Cotton Mills Case (1896) It means that an auditor is simply expected to conduct audit with reasonable care and skill and in accordance with the current standard audit practices He need not undertake detailed investigations in general, unless there is something to arouse his suspicion and which may necessitate the detailed checking If he conducts audit with pre-born suspicion assuming that every employee is dishonest, and behaves like a 'detective' or a 'bloodhound', he would not be able to perform his duties well That is why he must behave like a watchdog who, in general, makes a distinction between a honest and dishonest person and acts accordingly

It should also be noted that if an auditor fails to discover frauds he may not be failing in his duty It may be noted that fraud and other irregularities may not be disclosed by an annual audit and even a detailed audit may not uncover certain types of frauds Under such circumstances, the question whether it will be possible to hold the auditor liable if he could not unearth the existing fraud which resulted into a loss to the company (If it is proved that the auditor should have been able to discover the fraud had he exercised reasonable care and skill, he would be held liable but, not otherwise)

His *liabilities with regard to consequential losses, i e*, losses due to his previous negligence, should be determined in the similar fashion as above.

The auditor cannot be held liable to the third parties for damage caused to them by his negligence It is because he is not employed by them and there is no contractual relationship between the auditor and the third parties He should, however, realise his moral duty towards third parties and act honestly as they may rely upon the statements issued by him and carry on transactions with the client.

Any agreement on the part of the auditor with his client restricting the liabilities will be void to that extent if the duties of the auditor have been defined and laid down by any statute He will be held liable inspite of any express agreement to the contrary

(b) **Liability for Misfeasance** The term 'misfeasance, implies breach of trust or breach of duty An auditor has to perform certain duties which may arise out of a contract with the client as in the case of sole traders and partnerships, or it may be statutory as laid down under various statutes For example, the duties of an auditor have been statutorily laid down in the Companies Act, 1956 If the auditor does not perform his duties properly and as a result his client suffers, he may be held liable for misfeasance

Legal Decisions There have been several cases[1] before the Courts in connection with the civil liability of an auditor We briefly mention here some of the important cases. They are studied in detail in the appendix.

1. See appendix for details of all the relevant cases.

In *re London and General Bank* (1895), it was held that an auditor is guilty of misfeasance if he does not draw the attention of the shareholders about the facts of the case in clear words through his report There was overvaluation of assets in this case and the auditor had merely stated in his report to the shareholders that "the value of the assets as shown in the Balance Sheet is dependent upon realisation"

In *re The Kingston Cotton Mill Company* (1896), it was held that it is not the duty of the auditor to take stock and that he is not guilty of negligence if he accepts the certificate of a responsible official provided there are no suspicious circumstances In this case, there was overvaluation of stock and the auditor had relied upon the summary of stocks as certified by the manager

In *Irish Woollen Company Limited v Tyson and others* (1900), it was held that an auditor is liable for damages caused to his client for not exercising reasonable care and skill in the performance of his audit In this case, there was considerable understatement of trade liabilities and suppression of some of the purchase invoices It was felt that such falsification might have been discovered by the auditor provided he had called for the creditors' statements and checked the same with the respective Ledger Accounts

In *The London Oil Storage Company Limited v Seear, Hasluck and Co* (1904), it was held that an auditor is liable for any damage sustained by the company if he omits to verify the existence of the assets shown in the Balance Sheet It is an important duty of an auditor to verify the existence of assets stated in the balance sheet In this case, the company suffered a loss because of negligence on the part of auditor to verify the existence of the petty cash in hand which was shown at £ 796 but in fact the petty cash was only £ 30

In *Leads Estate Building and Investment Company v Shepherd* (1887), it was held that an auditor is liable for negligence if he fals to satisfy himself that the transactions are ultra vires the directoirs He must see that the balance sheet is a true and an accurate representation of the Company's affairs "It was no excuse that the auditor had not seen the Articles when he knew of their existence" In this case, the Balance Sheet had presented a false and misleading state of affairs and contained fictitious items included with a view to declare dividends The provisions of the Articles of Association were also not complied with The auditor, however, was not furnished with a copy of the Articles

In *Arthur E Green and Company v The Central Advance and Discount Corporation Ltd* (1920), it was held that an auditor is guilty of negligence if he accepts the schedules of bad debts supplied to him by the Managing Director, provided it is apparent that other debts not included in the schedule are also irrecoverable In this case, the auditor had accepted a schedule of bad debts supplied by the managing director although the schedule was inaccurate and did not include many old and statute-barred debts

In *Armitage v Brewer and Knott* (1932), it was held that an auditor is liable for negligence if he is unable to discover the defalcation carried on by an employee The defalcations aggregated to £ 1400 and consisted of fraudulent alterations of time sheets and petty cash vouchers It may be noted that in this case detailed audit was specifically called for as plaintiff had arranged with the auditor that they would vouch all payments with receipts in petty cash, check calculations and additions of wage sheets, check entries in wages book, and check weekly totals with other detailed transactions

In *re Thomas Gerrard & Sons Ltd* (1967), it was held that it was certainly incumbent on the company auditors, when once material alterations affecting valuation came to their notice, to take all reasonable steps to verify that the supporting vouchers and records relating to the taking of stock were in order In this recent English case, the auditors had noticed some alterations in this invoices, but he did not make further enquiries in this connection after accepting the explanations and assurances as to the stock-taking procedure from the managing director of the company.

In *the Union Bank of Allahabad case* (1925), the auditor was held liable for negligence as he did not act with reasonable care and skill In this case, the manager of the Bank had borrowed large sums of the company's money for his personal use and for his relatives without providing any proper security for the same and the auditor passed the accounts presented by the manager

In *State v G M Oka* (1952), the auditor was held liable for negligence for not verifying the securities before issuing certificates for them.

In *Deputy Secretary to the Government of India, Ministry of Finance v S N Das Gupta* (1955), the auditor was held liable for not verifying the cash balance and for not giving information to the shareholders in clear words

In *The Fairdeal Corporation, Limited Bombay v K Gopalkrishna Rao* (1957), the auditor was held guilty for negligence He was appointed auditor for the Madras branch of a limited company at Bombay and failed to report to the Bombay office that some entries in the Bank Pass Book had not been passed through the Cash Book of the branch

In *Superintendent of Police v N Rajamany* (1961), the auditor was held guilty for gross negligence as he had failed to disclose the total indebtedness of the directors in the Balance Sheet and to report on the numerous alterations and fictitious entries in the books of account of the Bank It is to be noted that it was disclosed in the course of investigation of the affairs of a bank in liquidation

In *G P Acharya* (1962), the auditor was held guilty for gross negligence as he had issued false certificate regarding a firm The certificate was given with regard to the export of onions by the firm during a spcified period and that was submitted to the Chief Controller of Exports, Calcutta

In *Registrar of Companies, Kerala State v T S Vaidyanath Iyer* (1963), an inspector was appointed by the Government to investigate into the affairs of a company He reported that the company auditor failed to conduct complete audit, verify the assets and liabilities in the Balance Sheet and report on the vouchers which were quite objectionable On the basis of this report, the auditor was held guilty for gross negligence

2 CRIMINAL LIABILITY

Criminal liability of an auditor arises because of offences against the statutory provisions specifically laid down In such cases an auditor is liable not only to the shareholders but also to the State It may arise because of some criminal act on his part or gross neglect of certain provisions of the Acts Lancaster mentions that it arises "from errors in the performance of audit duties involving criminal neglect or, of course, actual fraud or conspiracy in which intention to do what is known to be illegal is an essential element"[1] Thus, according to him, it may be because of criminal neglect, actual fraud or conspiracy of the auditor

In case of criminal liability, an auditor is punishable with fine or imprisonment or both as might be provided in the relevant Act

In *Dumbell's Banking Co Ltd* (1900), the auditor was held liable for having joined in the issue of false balance sheet, knowing it to be false Similarly, in *Farrow's Bank Ltd* (1921), he has criminally held liable for conspiracy and fraud in connection with the published accounts of the bank

The following two cases on criminal liability are worth mentioning

Rex v Lord Kylsant and Another (1932) It is also known as Royal Mail Steam Packet case In this case the auditor along with the chairman of the company was prosecuted criminally for publishing the annual reports knowing them to be false in a material particular with an intention to deceive the shareholders The main charge against them was that at a time when the gross earnings of the shipping fleet were not adequate to show a trading profit, the excessive provision created in previous years was utilised to show surplus in the accounts In fact, the company had drawn £4,39,000 from the secret reserves, created in past The defendents, however, were acquitted but the case is notable in the sense as it requires that there is a need for higher standards in methods of presentation of information in the published accounts

Rex v Hinds, Musgrave and Steven (1950) This case is related to an engineering concern and prosecution charges were laid on directors and auditors of the company The main charge was that a "forecast" was made that in 1947 there would be a profit of not less than £1,00,000 and for 1948 they would not be less than

1 *Principles and Practice of Auditing*, Third Edition, p 55

£1,50,000 It was alleged that there was no reasonable ground for such estimate of profit This estimate of profit was mentioned in the prospectus issued in December 1947 which invited the public to apply for the preference shares The directors were held guilty of the charge, but the auditor, however, was acquitted, as it was held that the forecasts were not a part of the auditor's report

3 CONTRACTUAL LIABILITY

The contractual liability arises out of the contract entered between the auditor and the client Unlike the statutory liability which arises out of the provisions laid down in the various statutes, the contractual liability arises mainly in case of the sole traders and partnerships. In those cases there are no Acts governing the appointment or rights or duties of an auditor, as mentioned in the previous chapter In the absence of any statutory provision, the question of his liability has to be settled in accordance with the terms and conditions settled by the auditor with his client in the agreement That is why it is necessary that such agreements should be in writing and the terms of duties, responsibilities and scope of work should be stated in clear words

The absence of any statutory provision should not be taken to mean that the auditor's responsibilities are not onerous in such case As a matter of fact this makes the situation complex and his liabilities may be extended to a great extent Anyhow, the auditor cannot be held liable in case he follows the instructions given to him and exercises reasonable care and skill required in the particular circumstances of the case He must perform his duties truthfully and honestly and if during the course of audit some suspicion is aroused, he must take pains to probe deep into the matter.

The question of negligence has to be considered on the merits of each particular case He will be negligent if he does not exercise reasonable care and skill which a reasonably competent, careful and cautious auditor would exercise in the particular circumstances of each case

If the auditor has been called upon to carry on the partial audit, he must take care to get definite instruction in this regard And while giving his report he must note this fact therein about the limited responsibilities undertaken He must write everything in precise words to avoid any ambiguity and prevent any dispute in future

He will be held liable if he does not observe high standards of his profession and work honestly Sometimes he is put in a delicate situation because of the frauds or irregularities carried on by the client's parents or close relatives, but he must not give way to emotions He must honestly and truthfully report the matter to his client in clear words without any hesitation, laying aside all other considerations If he does not do so, he fails in the performance of his duties any may be held liable for the same

His liabilities in such cases with regard to third parties, *i e*, bankers, creditors or prospective partners etc , are limited He can be held liable in case of frauds committed by him, but if he has acted honestly, he cannot be held liable by them because he owes no duty to a person other than his client

4 STATUTORY LIABILITY

The statutory liability of an auditor for the accounts audited by him are those liabilities which have been specially laid down in the statutes of the country In India he may be held liable under the following main Acts

(*i*) Companies Act, 1956,

(*ii*) Chartered Accountants Act, 1949, and

(*iii*) other Acts, such as Banking Companies Act, 1949, Insurance Act, 1938, Indian Penal Code Income Tax Act, 1961

(1) Liability under Companies Act, 1956 *Civil Liability* Under the Companies Act, the civil liability of an auditor may arise in the following cases

(*i*) If an auditor has misapplied or retained or become liable or accountable for any money or property of the company, or has been guilty of any misfeasance or breach of trust in relation to the company, the Court may compel him to repay or to restore the money or property of or any part thereof with interest at certain rate or to contribute such sum to the assets of the company by way of compensation (section 543) The proceeding should be instituted within the prescribed period This section is applicable only in case of winding up of the company, and "merely provides a more expedient form of procedure and creates no substantial safeguard for the interests of the company"

(*ii*) He shall be liable with regard to misstatements in the Prospectus of the Company under section 62 The auditor is liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the Prospectus issued by the company for any loss or damage he may have sustained But this liability will arise only if the auditor made any untrue statement which has been included in the Prospectus and the subscriber was made to suffer loss because of this He may not be held liable if he proves that,

(*a*) having consented, he withdrew his consent before the issue of Prospectus and that it was issued without his authority or consent, or

(*b*) it was issued without his consent or knowledge and on becoming aware of this he gave a public notice of the fact, or

(*c*) after its issue but before allotment of shares or debentures, he withdrew his consent and gave a public notice stating reason for withdrawal, or

(*d*) for every untrue statement, he had reasonable grounds to believe that the statement was true

Criminal Liability The criminal liability of a company auditor extends the following cases

(*i*) If he makes a false statement with material particular in returns, reports, prospectus or others statements etc knowing to be false or omits any material fact knowing them to be material For example, if an auditor certifies a Balance Sheet of a company to be true and fair knowing that it is not, so, he would be criminally held liable In such a case, he will be liable for punishment with imprisonment which may extend to two years, and shall also be liable to fine (section 628).

(*ii*) If he gives false evidence intentionally (*a*) upon any examination upon oath or solemn affirmation, authorised under the Act, or (*b*) in any affidavit, deposition or solemn affirmation, in or about the winding up of any company under this Act, or otherwise in or about any matter arising under this Act, he shall be punishable with imprisonment for a term which may extend to seven years and shall also be liable to fine (section 629)

(*iii*) An auditor may be prosecuted by the liquidator, as an officer of the company, during the course of winding up of the company for delinquency (section 545) An auditor, however, can be prosecuted under this section if it is proved that (*a*) the statement made was false in material facts, (*b*) the auditor wilfully made such a false statement, and (*c*) the statement complained of has been made in any return, balance sheet, certificate or any other document required to be made any under provisions of the Companies Act

(*iv*) If he wilfully makes a default, in making his report to the shareholders according to the provisions of sections 227 and 229 If his default is proved wilful, he will be punishable with fine which may extend to one thousand rupees (section 233)

(*v*) (*a*) If he is found guilty of destruction, mutilation, alteration, falsification or secreting of any books, papers or securities he may be held liable (*b*) Also if he makes any false or fraudulent entry in any register, books of account or document of the company, he will be liable for punishment with imprisonment for a term which may extend to seven years and shall also be liable to fine (section 539)

(*vi*) If he authorises the issue of the Prospectus of a company containing a false and untrue statement In such case, he will be held liable for punishment with imprisonment for a term which may extend to two years, or with fine which may extend to five thousand rupees (section 63) However, he will not be held liable if he proves

either that the statement was immaterial or that he had reasonable ground to believe that the statement was true

(*vii*) If he is a party to the issue of Prospectus including statement purporting to be made by him as an expert, unless he is not interested in the formation or promotion or in the management of the company He may be punishable with fine which may extend to five thousand rupees (section 57, 58 and 59)

(*viii*) If he induces a person fraudulently to invest moneys by knowingly or recklessly making a statement or promise which is false or misleading, or if he dishonestly conceals the material facts He shall be punishable with imprisonment for a term up to five years or with fine up to ten thousand rupees, or both (section 68)

Indemnification The Companies Act, 1956 contains provisions for the indemnification or relief to the auditor from liability He may be indemnified or granted relief in the following cases —

(*i*) An auditor may be indemnified by the company against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or discharged He may also be indemnified in connection with any application under section 633 in which relief is granted to him by the Court But such indemnification shall be in pursuance of the Articles of the company or any agreement with the company (section 201)

(*ii*) He may be granted relief, wholly or partly, if in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an auditor of a company, it appears to the Court that he has acted honestly and reasonably [section 633 (1)]

(*iii*) An auditor of a company may be indemnified out of the assets of the company against any liability incurred by him in respect of a proceeding, whether civil or criminal, (*a*) in which judgment is given in his favour, or (*b*) in which he is acquitted or discharged.

(ii) **Liability under Chartered Accountants Act, 1949** Liability of Chartered Accountant, acting as an auditor, may be in the form of disciplinary proceedings under the Chartered Accountants Act, 1949 It may arise on account of professional misconduct on the part of auditor

Professional misconduct has been defined under section 22 of the Chartered Accountants Act, 1949 as under "For the purpose of this Act, the expression 'professional misconduct' shall be deemed to include any act of omission specified in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Council under sub-section (1) or section 21 to inquire into the conduct of any member of the Institute under any other circumstances"

There are separate provisions for professional misconduct in relation to (*a*) chartered accountants in practice, (*b*) members of the

Institute in service, (*c*) members of the Institute generally, (*d*) chartered accountants in practice requiring action by a High Court, and (*e*) members of the Institute generally requiring action by a High Court

A Chartered Accountant, in practice or acting as auditor, will be deemed guilty of professional misconduct mainly, if he

(*i*) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading ,

(*ii*) fails to report a material mis-statement known to him to appear in a financial statement ,

(*iii*) is grossly negligent in the conduct of his professional duties ,

(*iv*) fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficiently material to negate the expression of an opinion ,

(*v*) fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances

The Council, under section 21, refers the case of professional misconduct on the part of the members to the Disciplinary Committee The latter holds the enquiry and reports its findings to the Council In case the Council finds, on the basis of its report, that the member is guilty of professional misconduct, it gives chance to the member to explain his conduct. After hearing him, it may make any of the following orders —

(*i*) reprimand the members ,

(*ii*) remove his name from the Register for such period, not exceeding five years, as the Council thinks fit In case it appears to the Council that the member ought to be removed for a period exceeding five years or permanently, it cannot make such order but must forward the case to the High Court with its recommendations thereon

If the misconduct on the part of the member is other than that specified in the First Schedule, the Council has to refer the case of the High Court with its recommendations thereon

Legal Decisions There have been several legal cases in which the auditor was found guilty of professional misconduct Some of the important cases are given below —

In *Registrar of Companies, Bombay v P M Hedge* (1954), it was held that it is the duty of the auditor of a bank, except in special circumstances, to verify the cash in hand on the date of the Balance Sheet and even when at a later date he makes a check, if he does not

examine the intermediate transactions, he fails in his duty to satisfy that the assets were there It is the duty of an auditor to have mentioned in his report that there was non-compliance with the statutory directions In this case the disciplinary action against the auditor was brought by the Registrar of Companies, Bombay

In *Commissioner of Income-Tax, Madras v G M Dandekar* (1952) a disciplinary action was taken against the auditor who was asked to audit the accounts and prepare the income tax returns of the assessee It was held that "there can be no negligence unless there is a duty cast upon the person to do a particular act and he fails to do so"

In *Deputy Secretary to the Government of India, Ministry of Finance v S N Das Gupta* (1955) it was held that if an auditor has not performed his duty he cannot take a defence in a disciplinary proceeding that he had told the shareholders that he had not done it It was also held that in a bank audit cash balance must be verified by the auditor

In *S Ganesan v A K Joscelyne* (1957) it was held that "professional misconduct on the part of a person exercising one of the technical professions cannot fairly or reasonably be found merely on a finding of a bare non-performance of a duty or some default in performing it The test must always be whether in addition to the failure to do the duty, partial or entire, which had happened, there had also been failure to act honestly and reasonably"

In *R B Basu v P K Mukherjee* (1957) it was held that a Chartered Accountant will be held liable for misconduct if it is proved that he charged fees for his professional employment on a percentage of profits or as contingent on results

In *Re K C J Satyavadi* (1955), the auditor was held guilty of misconduct, as he had sent a letter to the Secretary to the Ministry of Commerce and Industry soliciting auditing work

In *Institute of Chartered Accountants v B V Warekar*, the auditor was held guilty of misconduct for not having disclosed the material fact known to him and non-disclosure of which rendered the statement misleading

(*iii*) **Liability under other Acts** Under section 46 of the *Banking Companies Act*, 1940, if an auditor in any return, Balance Sheet or other document, wilfully makes a statement which is false in any material particular, knowing it to be false, or wilfully omits to make a material statement, he is punishable with imprisonment for a term which may extend to three years and is also liable to fine Under section 46A, he is deemed to be a public servant for the purposes of Indian Panel Code

Under section 45G, an auditor of a banking company may be publicly examined in the winding up proceedings On such examination, the High Court may make an order, if he is not found fit to

act as an auditor, that he will not act as auditor of *any company* for such period not exceeding five years as may be specified in the order

Under section 104 of the *Life Insurance Corporation Act*, 1956, an auditor may be sentenced to imprisonment or fine or both if he gives a false statement knowingly in any return, report or other such forms to be issued under the Act

Under section 197 of the *Indian Penal Code*, if any person including auditor issues or signs a certificate required by law to be given or signed, or relating to any fact of which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, he shall be punishable in the same manner as if he gave false evidence

Under section 278 of the *Income Tax Act*, 1961, if any person including an auditor abets or induces in any manner another person to make and deliver an account, statement or declaration relating to any income chargeable to tax which is false and which he either knows to be false or does not believe to be true, he shall be punishable with simple imprisonment which may extend to six months or with fine which may extend to one thousand rupees or with both

5 LIABILITY TOWARDS THIRD PARTIES

There are several persons who take advantage of the accounts audited by the auditor They rely completely upon the final accounts certified by the auditor and enter into transactions with the company without any further enquiry These parties, besides the client, may be the creditors, the bankers, the tax authorities, the prospective shareholders etc The question arises whether the auditor owes any duty to the third parties and can he be made liable to them for negligence or breach of duty or trust or fraud etc ?

For Negligence In general, it has been judicially held that the auditor is not liable to third parties since no contractual obligation exists between the auditor and the third parties Since he is not appointed by them, he owes no duty to them and hence there is no question of any liability to them He cannot be held liable unless he owes any duty to the person who holds him liable for damages caused to him "A man is entitled to be as negligent as he pleases towards the whole world if he owed no duty to them"

In a British case of *Candler v Crane, Christmas and Company* (1950), it was held by the Court of Appeal that "there was no contractual or fiduciary relationship between the parties and that, therefore, the plantiff could not maintain an action for negligence against the defendants" In this case, instruction was given to the auditor, the defendant, by the managing director of the company to prepare the accounts of the company The defendants were told that such accounts would be used to induce the plaintiff to invest money in the company The defendants prepared the accounts negligently but had not committed any fraud as such The accounts were shown to

the plaintiff in the presence of the defendant's clerk and the plaintiff, relying on the accuracy of the accounts, subscribed for shares in the company The company went into liquidation and the plaintiff lost the money invested in the company He brought an action against the defendant for negligence and also for breach of duty as the defendant did not let him as a shareholder know the true position of the company It was held that the defendant did not owe any duty to the plantiff No contractual relationship existed between the parties and the defendant cannot be held liable for negligence It was also held that there was no breach of duty on the part of the defendant towards the plaintiff since there was no relationship of shareholder and auditor between the parties as by then the plaintiff had not invested the money for purchasing the shares of the company He was not a shareholder but simply a prospective shareholder and in that capacity the auditor owed no duty to him Lord Denning, however, dissented, and said " the accountant, who certifies the accounts of the client, is always called upon to express his personal opinion whether the accounts exhibit a true and correct (now fair) view of his client's affairs, and he is required to do this not so much for the satisfaction of his own client but more for the guidance of shareholders, investors, revenue authorities, and others who may have to rely on the accounts in serious matters of business "

In 1921 a similar case came before the Court in United States In this case of *Ultramares Corporation v Touche and Others*, the question of auditor's liability of this nature was thoroughly reviewed by New York State Court of Appeals In this case the plaintiff, a banker, advanced loans to the company relying upon the accuracy of its Balance Sheet which had been signed by the auditor The plaintiff lost the money lent since the Balance Sheet was defective and brought an action against the auditor for damages The judgment in this case also was given in favour of the auditor on the question of negligence

The Indian Courts also hold the same view that an auditor does not owe any duty to the third parties and hence he cannot be held liable by them In *Commissioner of Income-Tax, Madras v G M Dandekar* (1951) it has been held that the defendant owed no duty to the Income-Tax department since he was not employed by it and there was thus no negligence involved Venkatarama Ayyar, J, in the course of this judgment said, "The charge is that he (auditor) owed a duty to the department (Income-Tax Department), to himself investigate the truth and correctness of the accounts of the assessee and not merely to act as their post office in transmitting them We do not agree that the respondent (auditor) is under any such duty to the department and, therefore, no question of negligence arises "

However, in *Hedley Byrne & Co Ltd v Hellen & Partners Ltd* (1963) the majority decision in the Christmas & Co case was overruled unanimously by the House of Lords It may be mentioned here that this case does not directly concern the accountant but the principle laid down in this case is applicable to him It was said,

"If, in the ordinary course of business or professional affairs, a person seeks information or advice from another, who is not under contractual or fiduciary obligation to give the information or advice, in circumstances in which a reasonable man so asked would know that he was being trusted, or that his skill or judgment was being relied on, and the person asked chooses to give the information or advice without clearly so qualifying his answer as to show that he does not accept responsibility, then the person relying accepts a legal duty to exercise such care as the circumstances require in making his reply, and for failure to exercise that care an action for negligence will lie if damage results" Thus, the professional auditor may be held liable to third parties in certain circumstances

There has been some change in the attitude of courts in U K and U S A in this connection In recent judgments, a broader view is being taken and auditors are being held liable towards third parties under certain circumstances

The Institute of Chartered Accountants in England and Wales also feels that the auditors may be held liable to third parties "in limited sense" According to it, the third parties may hold an auditor liable for his negligence, if they suffer a loss "in circumstances where the accountant knew or ought to have known that the reports, accounts or financial statements in question were being prepared for the specific purpose or transaction which give rise to the losses and that they would be shown to and relied upon by third parties in that connection"

With the change in time the views change and with this the "generally accepted audit standards" also change There is no doubt that the main responsibility of an auditor is to the person who employs him but at the same time he owes certain moral duties to the third parties also and thus he cannot ignore his responsibilities towards them for negligence

For Frauds The third parties, however, can hold him liable in tort, in case there has been any fraud on the part of the auditor Even if there is no contractual obligation between the auditor and the third parties, the latter can sue the auditor if the report of the auditor is of such a nature as amounts to fraud As described above, the action for negligence cannot be brought against the auditor but sometimes the negligence may amount to fraud and he may be sued for that But it must be proved that the auditor did not act honestly and the negligence is of an extremely gross and culpable nature and the auditor knew it The principles laid down in *Derry v Peek* (1882) are of special importance in this case The following points were decided in this case,

(*a*) that the statement or balance sheet signed by the auditor was materially untrue,

(*b*) that the statement, etc, was made with an intent that a third party should act on it,

(*c*) that the auditor knew that the statement, etc , was untrue,

(*d*) that the third party did act upon such a statement, etc , and consequently suffered a loss, and

(*e*) that the auditor gave his consent for the inclusion of such a statement in the prospectus

Thus, the auditor can be held liable to the third parties only when the above mentioned facts are proved against him

6. LIABILITY FOR UNLAWFUL ACTS OF THE CLIENT

An auditor may obtain knowledge about the unlawful acts or defaults committed by his client during the course of his audit The question arises whether he should inform the proper authorities about it and whether he can be held liable if he does not do so It is a difficult question indeed since it involves breach of confidence placed in him by his client It is felt that if the default is a misdemeanour, it is not the duty of an auditor to inform the facts in his possession to the authorities concerned If the offence is felony, he should seek legal advice as to what he should do In the opinion of the Institute of Chartered Accountants in England and Wales, he must consider the following points[1] —

(*i*) He must not do anything to assist the client to commit any criminal offence

(*ii*) Whether the possible consequences of the offences are such as to prevent the accounts which he is engaged in preparing or auditing from giving a true and fair view and, therefore, call for appropriate reservations in his report on such accounts

(*iii*) Whether in all the circumstances he is prepared to continue to act for the client

Thus, under such circumstances, he must act very carefully He must not do such things which may unnecessarily injure the confidence of his client in him If necessary, he should terminate his association with the client rather than open himself to any such liability

7 LIABILITY TO ARTICLE CLERKS

The auditor may be held liable to his article clerks in the following cases

(*i*) If he does not act honestly with his article clerks (*Anupam Rai v P.K Mukerji*, 1956).

(*ii*) If he removes any of his article clerks without any prior notice (*Indian Institute of Chartered Accountants v K C J. Satyavadi*, 1959)

1 Spicer & Pegler, *Principles Auditing*, Second Indian Edition, pp 48-49

(*iii*) If he does not return the premium taken by him from his article clerks (*Anukool Chandra Samadar v Sudhansu Mohan Sen Gupta*, 1957)

(*iv*) If he gives a false certificate of returning premium to his article clerks (*The Council of the Indian Institute of Chartered Accountants v Mahesh Narain Bhargava*, 1958)

The auditor, however, cannot be held liable to his article clerks to pay compensation to them in case their services are terminated by the auditor The question of payment of compensation to a retrenched or dismissed worker arises under the Industrial Disputes Act, 1956 It could arise only if the business in which he was employed was an 'industry' within the meaning of section 2(J) of the Act

The consensus of decisions of the High Courts in this connection is that the business of the Chartered Accountant or Auditor, whether carried on by an individual or a firm, is not an industry within the meaning of the provisions of the Act None of the provisions, therefore, is applicable to them The fact that they employ clerks or other persons to assist them does not make any difference to the legal position

In Rama Krishna Iyer Vaidyanath v Fifth Industrial Tribunal of West Bengal (1968), it was held that the firm of Chartered Accountants cannot be held liable for the payment of compensation to the dismissed clerk under the Industrial Disputes Act The learned judge of the Calcutta High Court observed · "The fact that a chartered accountants engages the services of clerks to do the work of checking and vouching, castings and postings, makes no difference to the position The subsidiary work whether done by audit clerks or other qualified accountants is purely of an incidental type and is intended to assist the chartered accountant in doing his job and has no direct relation to the professional service ultimately rendered by the chartered accountant . the test of essential co-operation between the employer and employees is entirely absent in the case of an undertaking of a chartered accountant Applying the other test, namely, the co-operation between capital and labour, it must be held that there is no such co-operation as the only capital of a chartered accountant is his professional qualification, skill, training and reputation"

Similar problems was raised in *T K Menon and Co., Calicut v District Labour Officer, Kozhikode* (1967), which came up before the Kerala High Court for decision. It was held that the Chartered Accountants constituted a skilled professional class There was no essential co-operation between the chartered accountant and his clerks as employer and employees. It was further held that chartered accountant was allowed to practice as such in view of the special and technical qualifications he possessed and there was no investment of any capital in the practice of the profession except for the qualification and experience he possessed.

In Fraser and Rose v Sambasiva and Another (1967) the firm of chartered accountants had employed a stenographer and retired him on his completing his sixtieth year The stenographer instituted a claim in the Labour Court claiming Rs 7,254 as retrenchment compensation and wages in lieu of one month's notice The firm's plea was that it was not an industry within the meaning of the Industrial Dispute Act It was held that professional services depended on the personal qualifications and ability of the donor of the services and were not included in the word "undertaking" in the definition of industry in the Industrial Disputes Act The learned judge of Madras High Court, in the case, observed "chartered accountants and auditors definitely do constitute a 'learned' or 'liberal profession', which cannot be termed as industry within the definition '

NOTABLE EXCERPTS FROM JUDGMENTS

In *Leeds Estate Building & Investment Co v Shepherd* (1887), Sterling J, stated that "It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it is a true and accurate representation of the company's affairs It was no excuse that the auditor had not seen the Articles when he knew of their existence "

In *London and General Bank Ltd* (1895), Lord Justice Lindley stated "It is not part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do An auditor has nothing to do with the prudence or imprudence of making loans with or without security It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably, it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders, His business is to ascertain and state the true financial position of the company at the time of audit, and his duty is confined to that. But then comes the question, How is he to ascertain such position? The answer is By examining the books of the company But he does not discharge his duty by doing this without inquiry and without taking trouble to see that the books of the company themselves show the company's true position He must take reasonable care to ascertain that they do Unless he does this, his duty will be worse than a farce Assuming the books to be so kept as to show the true position according to the books, and to certify that the balance sheet presented is correct in that sense But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company An auditor, however, is not bound to do more than exercise reasonable care and skill, in making enquiries and investigations He is not insurer , he does not guarantee that the books do correctly show the true position of the company's affairs , he does not guarantee that his balance sheet is accurate according to the books of the company If he did he would be responsible for an error on his part, even if he were himself deceived without any want of reasonable care on his part—say, by the

fraudulent concealment of a book from him His obligation is not so onerous as this "

"Such I take to be the duty of the auditor , he must be honest, that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true What is reasonable care in any particular case must depend upon the circumstances of that case Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient , and in practice, I believe, businessmen select a few cases haphazardly, see that they are right, and assume that other like them are correct also Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion , and he is perfectly justified in acting on the opinion of an expert where special knowledge is required "

It was added that "the duty of an auditor is to convey information, not to arouse inquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it "

In *The Kingston Cotton Mills Co Ltd* (1896), Justice Lopes stated "It is the duty of an auditor to bring to bear on the work he has to perform, that skill, care and caution which a reasonable, competent, careful and cautious auditor would use What is reasonable skill, care and caution, must depend on the particular circumstances of each case. An auditor is not bound to be detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong He is a watchdog, but not a bloodhound He is justified in believing tried servants of the company in whom confidence is placed by the company He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonable cautious and careful Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors So to hold would make the position of an auditor intolerable "

In *The Irish Wollen Co Ltd* v. *Tyson and Others* (1900), the learned judge stated: "Mr Kevans (auditor) seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it ; the investigation of the books he deputed to his assistants and it must be on the faith of their representations that he certified the balance-sheet I presume

this course is not unusual and that an accountant with a large business is not supposed to do everything himself The auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy He is not an insurer against fraud or error, and if fraud is alleged, it must be shown with precision the acts of negligence for which he is said to be responsible There was certainly no duty cast on the auditor to take stock What he did was to have the calculations checked in his office, and this was done with proper care an auditor has nothing to do with the terms upon which the company or a trader buys or sells"

In *Re City Equitable Fire Insurance Co Ltd* (1924), Justice Romer stated "Indeed, if once it be admitted that, in lieu of inspecting the securities personally, the auditor may rely upon the certificate of the person in whose custody the securities have properly been placed the auditor would be justified in accepting the certificate of any official of the company who happened to be in charge of the safe in which the securities are placed, supposing such official to be a reputable and responsible person At some time or other it will, I think, have to be considered seriously whether it is not the duty of an auditor to make a personal inspection, in all cases where it is practicable for him to do, whatever may be the standing and character of the person or company in whose possession the securities happen not be an auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left"

"I think he must take a certificate from a person who is in the habit of dealing with and holding securities, and whom he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment a trustworthy person to give such a certificate"

In *Re Republic of Bolivia Exploration Syndicate Ltd*, the learned judge stated "Auditors of a Limited company are bound to know or make themselves acquainted with their duties under articles of the company whose accounts they are appointed to audit and under the Companies Act for the time being in force And that, when it is shown that the audited balance sheet did not show the true condition of the company and that damage has resulted, the onus is on the auditors to show that this is not the result of any breach of duty on their part"

In *Re The Westminster Road Construction and Engineering Co Ltd*, (1932), the learned judge Benett stated 'It was settled law that an auditor did not discharge his duty if he merely saw that the balance sheet accurately represented what was shown by the books on the material date. His duty with regard to the ascertainment of unrecorded liabilities must depend upon the facts of each particular case and must be determined by the nature of the business carried on and the practice of the persons or bodies with whom the company did business, of sending in their invoices If the auditor

found that company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval, and that liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it became his duty to make specific inquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the balance sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had been omitted "

In *London Oil Storage Co Ltd* v *Seear, Hasluck Co* (1904), Alverstone, C J stated that the "auditor cannot shelter himself for and breach of duty under the neglect of the director , he is there to do his duty to the company , the only point on which the conduct of the directors may become material is upon the subordinate question as to whether there is anything to arouse the suspicion of the auditor and whether or not the loss has really been occasioned by the auditor's conduct " It was pointed out again that an auditor "has got to bring to bear upon his duties reasonable and watchful care If circumstances of suspicion arise, it is the duty of the auditor, in so far as those circumstances relate to the financial position of the company to probe them to the bottom "

In *Armitage v Brewer and Knott* (1932), Justice Talbot stated . "The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of the wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter , they undertook a vigorous check, and they did so because that was what their client wanted What was required of them in the circumstances entailed more laborious work and more vigilance "

In *Deputy Secretary to the Government of India, Ministry of Finance v S N Das Gupta* (1955), Justice Chakravarty stated that "It is now well settled that it is the duty of an auditor to verify not merely the arithmetical accuracy of the balance sheet but its substantial accuracy and to see that it includes the particulars required by the Articles and the statute and contains a correct representation of the state of company's affairs "

In *Re Union Bank of Allahabad* (1925), Justice Wallis pointed out that "unless auditors are to be held strictly to their legal liability, however honest they may be, the object of legislature in required certificate from them is absolutely defeated .. I hold that he (auditor) was utterly reckless and indifferent in his conduct as an auditor "

In *Devai & Sons Ltd v M S Krishnaswamy* (1952), the learned judge stated that "The respondent failed in his duty as an auditor in not drawing the attention of the shareholders to the fact that the sinking fund was not created as contemplated by the debenture trust deed and in not making clear that fact that the amounts shown as towards the sinking fund were borrowed from the managing agents"

QUESTIONS

1 Write an essay on 'Liability of Auditors'

2 Explain the civil liability of an auditor with the help of suitable legal decisions

3 What do you understand by the criminal liability of an auditor Explain the criminal liability of an auditor under the Companies Act, 1956

4 Is an auditor liable to the third parties ? Discuss it with the help of suitable legal decisions

5 "Auditor cannot be held liable if there is negligence without loss" Explain it fully

6 How can an auditor be held liable for misfeasance ? Explain it with the help of legal cases

7 Distinguish between the contractual and statutory liabilities of an auditor Explain the liability of an auditor under various statutes

8 Discuss an auditor's liability for (a) unlawful acts of the client, and (b) the article clerks

9 Discuss the liability of a company auditor under the following circumstances

(*i*) Failure to detect omission of liabilities by suppression of several invoices for goods supplied

(*ii*) omission to verify the petty cash though the balance of the petty cash has increased considerably as compared to the previous year

(*iii*) Non-detection of serious over-valuation of work-in progress leading to a declaration of a dividend in excess of true profits

Cite legal cases in support of your answer

10 Discuss the liability of (a) an honorary auditor, and (b) liabilities with regard to the consequential losses

11 "Ordinarily, an auditor is not liable to the third parties" Explain it and discuss the position of an auditor in this regard

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Audit of Banking Companies

Banking companies are the financial companies which deal mainly in receiving or lending cash They carry on numerous cash transactions every day which give an opportunity for intentional or unintentional errors or dishonesty That is why the audit of the books of account of banking companies is essential In this connection, Dicksee has remarked that "In dealing with the question of Bank Audits it is well to remember that one of the most controversial subejcts relative to professional practice is being discussed So far as possible, a position that few will care to assail will be occupied, but it is well to admit at once that the author considers the duties of a Bank Auditor to be very much more onerous than some other accountants admit, whatever the legal responsibilities may be."[1]

The banking companies in India are governed by the Banking Regulation Act, 1949 However, the provisions of the Companies Act, 1956 also apply to them except in so far as they are not inconsistent with that of the Banking Regulation Act, 1949

Fourteen nationalised banks are governed by provisions of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 Certain provisions of Banking Regulation Act, 1949 also apply to these banks Similarly, rural banks are governed by the Regional Rural Banks Act, 1976 The State Bank of India is governed by the provisions of State Bank of India Act 1955 and its subsidiaries are governed by State Bank of India (Subsidiary Banks) Act, 1959.

The auditor of a bank must be familiar with the relevant provisions of the Banking Regulation Act before he undertakes the audit of banks It is because this is the principal Act which is applicable, fully or partially, to various kinds of banks We mention them below.

Forms of Business In addition to the business of banking, a banking company may engage under Section 6 (1), in any one or more of the following forms of business —

(*i*) Borrowing, raising, or taking up of money, lending or advancing of money either upon or without security, drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lad-

1 *Auditing*, Fifteenth edition, p. 128

ing, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not, and various specified business

(*ii*) Acting as agent of Government or local authorities or other persons, carrying on agency business excluding the business of a managing agent or secretary and treasurer of a company

(*iii*) Contracting for public and private loans and negotiating and issuing them

(*iv*) Effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of share stock, debentures, or debenture stock of any company, or association and the lending of money for the purpose of any such issue

(*v*) Carrying of and transacting every kind of guarantee and indemnity business

(*vi*) Managing, selling and realising any property which may come into the possession of the company in full or part satisfaction of any of its claims

(*vii*) Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security for any loans or advances

(*viii*) Undertaking and executing trusts

(*ix*) Undertaking the administration of estates as executor, trustee or otherwise

(*x*) Establishing and supporting associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or their dependants, granting pensions and allowances and making payments towards insurance, subscribing to or guaranteeing moneys for charitable or benevolent objects

(*xi*) The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for its purposes

(*xii*) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company

(*xiii*) Acquiring and undertakings the whole or any part of the business of any person or company, when such business is of a nature enumerated or described above

(*xiv*) Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company

(*xv*) Any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage

Restrictions on business A banking company cannot—

(*i*) engage in any form of business other than the business of banking and the form of business enumerated above [Section 6 (2)]

(*ii*) engage itself, directly or indirectly, in trading activities (buying and selling commodities) or undertaking any activity other than usual banking activities (Section 8)

(*iii*) hold any immovable property howsoever acquired, except such as is acquired for its own use Such properties cannot be held by it for more than seven years from the date of acquisition or from the commencement of the Act, whichever is later Such period, however, may be extended by the Reserve Bank of India (Section 9)

(*iv*) hold shares in any company, whether as pledgee, mortgagee, or absolute owner, of an amount exceeding thirty per cent of its own paid-up share capital and reserves, whichever is less [Section 19 (2)]

There are restrictions on the nature of business of subsidiary companies which can be formed for the purposes specified therein or for such other purposes as are incidental to the banking business [Section 19 (1)]

Regulation of Capital There are provisions with regard to the minimum paid up capital It is provided that in case of banking company incorporated outside India, the minimum paid up capital and reserves shall not be less than fifteen lakh rupees It should be twenty lakh rupees if it conducts business in Bombay or Calcutta In the case of banking companies incorporated in India, they should not be less than five lakh rupees if it has places of business in more than one State It should not be less than ten lakhs of rupees in Bombay and Calcutta If its business is confined to one State only, it should not be less than one lakh of rupees (Section 11)

With regard to the subscribed capital, it should not be less than one half of the authorised capital. At the same time, the paid up capital should not be less than one-half of the subscribed capital The capital of the company should consist of ordinary shares only It may include preferential shares also if they were issued prior to 1st July, 1944 In case the banking company has been incorporated before the 15th January, 1937, these provisions would not apply [Section 12 (1)]

A prescribed minimum amount must be kept deposited with the Reserve Bank of India in the prescribed manner by the banking companies incorporated outside India [Section 11 (2b)] It must deposit with the Reserve Bank an amount calculated at twenty per cent of its profit for that year in respect of all the business transacted through its branches in India, as disclosed in the Profit and Loss Account prepared for that period It should be done as soon as possible after the expiry of each calendar year (Section 29) The Central Government may relax this provision on the recommendations of the Reserve Bank of India

Reserve Fund Every banking company incorporated in India must maintain a reserve fund It must transfer to such fund a sum equal to twenty per cent out of the balance of the profit each year as disclosed in the Profit and Loss Account But such transfers must be made before any dividend is declared, and until the reserve fund is equal to the paid-up capital Any appropriation from this reserve fund must be reported to the Reserve Bank of India within twenty-one day (Section 17)

Cash Reserves Every banking company, not being a scheduled bank, shall maintain in India by way of cash reserve a sum equivalent to at least three per cent of total of its time demand liabilities in India (Section 18)

Every scheduled bank is required to maintain with the Reserve Bank of India an average daily balance, the amount of which shall not be less than three per cent of the total of the demand and time liabilities in India (Section 42 of the Reserve Bank of India Act, 1934) The Reserve Bank of India has power to increase this rate upto fifteen per cent of the total of the demand and time liabilities

Every banking company shall maintain in India in cash, gold or unencumbered approved securities, valued at a price not exceeding the current market price, an amount which shall not at the close of business on any day be less than 20 per cent of the total of its time and demand liabilities in India (Section 24) After the amendment in 1962, this percentage has been increased to 25

Similarly, the assets in India of every banking company shall not be less than 75 per cent of its time and demand liabilities It should be at the close of business on the last Friday of every quarter or the preceding working day if Friday is a public holiday (Section 25)

Commission, Brokerage, Discount, etc on Sale of Shares No banking company can pay, directly or indirectly, by way of commission, brokerage, discount or remuneration in any form in respect of shares issued by it any amount exceeding two and a half per cent of the paid-up value of the said shares (Section 13)

Payment of Dividends No banking company can pay any dividend on its shares until all its capitalised expenses have been completely written off The capitalised expenses for this purpose include preliminary expenses, organisation expenses share selling brokerage, commission, amounts of losses incurred and any other item of expenditure not represented by tangible assets [Section 15 (1)]

It may, however, pay dividends on its shares without writing off—

(*i*) depreciation, if any, in the value of investments in approved securities in any case But such depreciation should not have been actually capitalised or otherwise accounted for

(*ii*) depreciation, if any, in the value of investments in shares,

debentures or bonds (other than approved securities) in any case But an adequate provision for such depreciation ought to have been made to satisfaction of the auditor of banking company

(iii) bad debt, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company [Section 15 (2)]

Loans and Advances No banking company can make any loans or advances on the security of its own shares, of grant unsecured loans or advances to any of its directors or to firms or private companies in which it or any of its directors is interested as partner, or managing agent or to any individuals, firms or private companies in case where any of its directors is a guarantor (Section 20)

Prohibition of Charge No banking company shall create any charge upon any unpaid capital of the company, and any such charge created shall be invalid (Section 14)

Similarly, no banking company can create a floating charge on the undertaking or any property of the company unless the creation of such floating charge is certified in writing by the Reserve Bank of India as not being detrimental to the interests of the deposition of such company (Section 14A)

Appointment of Managing Agents and Managing Directors No banking company can employ or be managed by a managing agent It cannot employ a person who has been adjudicated insolvent or whose remuneration or a part of remuneration takes the form of commission or of a share in the profits of the company The bonus, however, can be paid It cannot pay remuneration which, in the opinion of the Reserve Bank of India, is excessive (Section 10)

No appointment or reappointment of a managing director or whole time director, manager or chief executive officer can be made without the prior approval of the Reserve Bank Its prior approval will also be needed if an amendment of any provision with regard to appointment or reappointment or remuneration of those persons is made For this purpose, it is to be noted, the remuneration would also include any benefit, amenity or prequisites (Section 35B)

A common director cannot be appointed by a banking company It is provided that no banking company can appoint a person as a director who is a director of (*a*) any other banking company, or (*b*) companies which among themselves are entitled to exercise voting rights in excess of twenty per cent of the total voting rights of all the shareholders of the banking company (Section 16)

Accounts and Balance Sheet Every banking company, whether incorporated in India or outside India, is required to prepare a Balance Sheet and a Profit and Loss Account in respect of all the business transacted by it or its branches in India This has to be done at the expiry of each calendar year The accounts have to be prepared as on the last working day of the year in the forms set out

in the Third Schedule or as near thereto as circumstances admit. But if a banking company is incorporated outside India, the Profit and Loss Account may be prepared as on a date not earlier than two months before the last working day of the year (Section 29)

The form of Balance Sheet has been prescribed as given in Form A of Third Schedule Similarly, Form B of the Third Schedule prescribed the form of the Profit and Loss Account These forms are given at the end of this chapter

Authentication of Balance Sheet and Profit and Loss Account In case of banking company incorporated in India, the Balance Sheet and Profit and Loss Account shall be signed by the manager or the principal officer of the company If there are more than three directors of the company, they will be signed by at least three of those directors Where there are not more than three directors, they shall be signed by all the directors But in case of a banking company incorporated outside India, they shall be signed by the manager or agent of the principal officer of the company in India (Section 29).

The accounts and the Balance Sheet together with the auditor's report shall be published in the prescribed manner and three copies thereof shall be furnished as returns to the Reserve Bank of India within three months from the end of the period to which they refer The period, however may be extended by the Reserve Bank of India by further three months only (Section 31)

Three copies of Balance Sheet and other accounts and of the auditor's report must also be sent to the Registrar of Companies (Section 32)

There is a provision with regard to the display of the audited Balance Sheet by the companies incorporated outside India under Section 33 Such Companies are required to display a copy of their audited Balance Sheet and Profit and Loss Account, prepared under Section 29, and also a copy of their complete Balance Sheet and Profit and Loss Account, in a conspicuous place in its principal office and in every branch office

Audit of Accounts Under Section 30, in case of a banking company incorporated in India, the Balance Sheet and Profit and Loss Account prepared in accordance with Section 29 shall be audited person qualified to be an auditor of the companies under any law for the time being in force In case of the banking companies incorporated outside India, they shall be audited by such an auditor as aforesaid, or by a person duly qualified to be an auditor under the law of the country in which the company is incorporated

The powers, functions, duties and liabilities of the auditor shall be the same as of a company auditor Section 227 of a Companies Act, 1956

Internal Check. Numerous cash transactions take place daily in a banking company It necessitates the application of a high degree of internal check system so that dishonest practices may not take

place. Its importance lies also because of the fact that in practice detailed audit of accounts of a bank cannot be carried on by an independent auditor He may not be able to unearth all the arrears or dishonesty on the part of the bank employees For instance, if a dishonest manager of a bank makes a loans to his friends and shares the proceeds with them, the probability is that there will be nothing to arouse the suspicion of an auditor until the loans along with interest due on them become overdue Moreover, one loan can be paid off out of the proceeds of a new one and so on *ad infinitum* Thus it is rather impracticable for an auditor to discover a fraud of this kind. Such a situation can be controlled by a carefully planned and rigidly enforced internal check system It has been rightly emphasised that "In the case of the audit of a bank, it is not easy to see how any practicable system can infallibly detect fraud at once "[1]

Special Points of Internal Check. Usually banks employ a high degree of internal check Some important points, which should be kept in mind while enforcing a system of internal check in a banking company, are given as follows

(*i*) There should be segregation of various functions of bank employees as far possible so that—

(*a*) the work of each employee is independently checked by the other ,

(*b*) the Cashier must have neither any access to the Ledgers nor prepare or check bank statements ,

(*c*) the Ledger-keeper may not have any access to the Cash Book or Clearing House Journal ,

(*d*) the calling over of the records of the whole day may be done by those clerks who must not have recorded them ,

(*e*) a responsible official should check the Cash Book frequently

(*ii*) The duties of various employees should be changed from time to time No clerk should be allowed to work on one counter alone for a fairly long period.

(*iii*) A responsible official should frequently check the Balances on the various Ledgers current, deposit, savings banks and loans

(*iv*) The Pass Books, issued to the customers, should also be checked with the related Ledger Accounts by persons other than the Cashier and the Ledger keeper

(*v*) The securities lodged with the bank, whether on account of loans taken by the customers or kept under safe custody, should be kept under proper control and should be verified from time to time by some responsible official

(*vi*) There should be proper control over the various branches

1 Dicksee *Auditing*, p 133

which are usually spread over a large area of the country Surprise checking by the inspectors or auditors and some responsible officials of the bank should be made and any discrepancies should be reported to the Head Office It should be seen that such reports are duly complied with

(*vii*) The Bills Department should be under proper control It should be properly inspected by an independent person checking records of daily incomings and outgoing bills

(*viii*) The Clearing House transactions should be carefully checked daily

(*ix*) The internal audit staff should be quite vigilant to the enforcement of the internal check system It should maintain a proper record of all the checkings and inspection reports It should reconciliate various accounts from time to time to ascertain that they are correctly and properly maintained It should make suggestions from time to time to make an improvement in the system in the light of the expenses gained

(*x*) The controller-in-charge of the enforcement of the internal check system should see that the whole system is rigidly followed. Any discrepancy, which comes to his knowledge, should be properly dealt with Exemplary punishment should be given to those who indulge in dishonest practices A careful watch over the dishonest employees should be kept

Special Feature of a Bank Audit Before actually starting the audit of bank accounts the auditor should enquire about the internal check system prevailing therein He has to depend upon it to a great extent since it is impossible to carry on the detailed audit. After careful examination of the system in force, he should decide the scope of his audit

The special features of a bank audit to which the auditor has to pay particular attention are as follows

(*i*) Attend at the bank at the closing date of the financial year or on the date of that Balance Sheet with a view to verify the cash balances in hand at the date For this, he should count or weigh cash, notes, postal orders, cheques etc , which may remain with the bank on that date

(*ii*) Obtain and examine the confirmation certificates for the cash deposited with Reserve Bank of India and other banks

(*iii*) Verify and reconcile the balances with other banks in banker's Ledger with the pass books or statements Agree the balances with the General Ledger Verify the certificates confirming the balances

(*iv*) Verify the cheques, drafts, etc received too late on the date of the Balance Sheet for the purpose of clearing Ascertain later on that they come through in due course within next few days

(*v*) Verify the money at call and short notice with the call

deposit receipts If some securities are lodged for the purpose, check them with the schedules appended to the borrowing notes

(*vi*) Check the bills on hand which are unmatured and agree them with the General Ledger See that they have not become overdue for payment with the help of the date of maturity of the bills See that due provisions have been made for the dishonoured bills

(*vii*) See the limits fixed by the Board of Directors in connection with the bills discounted and purchased and ascertain that those have not been exceeded

(*viii*) Examine the rebates on Bills discounted carefully See that proper proportion of rebate for discount on bills due after the date of the Balance Sheet has been carried forward to the subsequent year

(*ix*) Check the balances of the Current, Fixed and Savings Banks Accounts with the help of the Schedules and ascertain that the totals of the Schedules agree with the balances of the respective Total Accounts in the General Ledger

(*x*) Check the balances of Loan Ledgers also as above

(*xi*) Check the investments made by the bank very carefully Ensure that same security has not been produced twice in support of investments Verify the investments in Government securities, debentures and shares by actual inspection thereof on the date of the Balance Sheet Obtain the confirmation certificates from other banks for the investments in their custody Check the balances in the Investment Ledger and agree the total investments with the Investment Accounts in the General Ledger See that proper provision has been made in case the book value of the investments is in excess of the market value See that those investments which are hypothecated are disclosed in the Balance Sheet as required See that the provisions of Section 19 (2) have been duly observed

(*xii*) Vouch the income from the investment and see that all such incomes accruing have been already brought into account

(*xiii*) Examine the securities deposited by the customers against loans and overdrafts etc See that all such loans are duly covered With regard to the unsecured advances the auditor must see that the bank has obtained confidential reports about the financial position of the borrowers and that according to the available informations the advances appears to be quite safe See that proper distinction between the secured and unsecured loans has been made and shown in the Balance Sheet accordingly See that adequate provisions have been made against bad and doubtful debts Ensure that the loans, advances, cash credits and overdrafts have been properly shown in the Balance Sheet duly classified as required

(*xiv*) See that all the interests payable on various accounts of the customers have been duly accounted till the date of the Balance

Sheet Similarly, ascertain that interest recoverable from the debtors is being regularly received from them

(xvi) Test randomly a few of the bank Pass Books and see that they tally with the Ledger Accounts

(xvii) Check the General Ledger Balances with the Trial Balance and the Final Accounts

(xviii) Pay special attention to the verification of the existence, value title and possession of assets with the bank Keep a note of all assets and securities written off specially with a view to create a secret reserve

(xix) Ascertain that Branch Returns are properly incorporated in the Head Office books and the Return is duly certified by the respective Branch Manager

(xx) Scrutinise the transactions in foreign currency and see how they have been incorporated in the accounts

(xxi) See that all the liabilities of the bank have been duly brought into account and shown in the Balance Sheet in the prescribed manner See that proper notes in connection with the contingent liabilities have been given as a footnote in the Balance Sheet or appended as a separate statement Verify the liabilities on account of letters of credit and guarantees given by the bank on or behalf of the constituents with the help of the documents and registers and it should be seen that proper margin is held

(xxii) Verify the contra items in connections with Bill for Collection or Acceptances, Endorsements, and Other Obligations Check them with the Registers maintained by the bank for recording these transactions

Auditor's Report In his report ot the shareholders of the banking company, an auditor is required to state the matters as provided under Section 227 of the Companies Act, 1956 In addition, he has also to state the following matters as provided in Section 30(3) of Banking Regulation Act, 1949, in case the banking company is incorporated in India

(*i*) Whether or not the information and explanations required by him have been found to be satisfactory

(*ii*) Whether or not the transactions of the company which have come to his notice have been within the powers of the company

(*iii*) Whether or not the returns received from branch offices of the company have been found adequate for the purposes of his audit

(*iv*) Whether the Profit and Loss Account shows a true balance of profit and loss for the period covered by such account

(*v*) Any other matter which he considers should be brought to the notice of the shareholders of the company

Specimen of Auditor's Report We give below a specimen of the auditor's report of Bank of India Ltd[1]

Auditor's Report to the Members

(1) We have audited the foregoing Balance Sheet of the Bank of India Ltd as at 31st December, 1967, and also the foregoing Profit and Loss Account of the Bank for the year ended upon that date, in which are incorporated the audited returns from all the Branches (except Karachi Branch—vide Note (2) to the Balance Sheet) of which 108 Branches have been audited between us and 108 branches by other Auditors

(2) We report that —

(*a*) we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit and have found them to be satisfactory ,

(*b*) the transactions of the Bank which have come to our notice have been within the powers of the Bank ,

(*c*) in our opinion, proper books of account as required by law have been kept by the Bank so far as appears from our examination of those books and proper returns adequate for the purposes of our audit have been received from all the Branches of the Bank ,

(*d*) the report on the account of the Branches audited by other Auditors have been forwarded to us and the same have been considered in preparing this report ,

(*e*) the Bank's Balance-Sheet and Profit and Loss Account dealt with by this report are in agreement with the books of account and the audited returns ,

(*f*) in our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required for banking companies and on such basis the said Balance Sheet gives a true and fair view of the state of the affairs of the Bank as at 31st December, 1967, and the Profit and Loss Account gives a true and fair view of the profit for the year ended upon that date

S B Billimoria & Co	A F Ferguson & Co
Chartered Accountants	Chartered Accountants

Bombay, 7th March, 1968

AUDIT OF NATIONALISED BANKS

The fourteen nationalised banks are governed by the provisions of the Banking Companies (Acquisition and Transfer of Undertakings)

1 *Economic Times*, 18th April, 1968

Act, 1970 Several provisions of the Banking Regulation Act, 1949 also apply to these banks.

These banks shall carry on and transact the business of banking as defined in Section 5 (b) of the Banking Regulation Act, 1949 They may engage in one or more forms of business specified in Section 6 (1) of that Act It may be pointed out that the provisions of Sections 10, 13 to 15, 17, 19, to 21, 23 to 28 and 29 [excluding Sub-section (3)], 31, 34, 35, 35 (A) and 36 [except Cl 1 (d)] of the Banking Regulation Act, 1949 also apply to these nationalised banks.

Each nationalised bank is required to close its books of account on December 31, each year according to Section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 Each bank is required to appoint, with the approval of Reserve Bank of India, auditors for the audit of its books of account Any person who is qualified to act as an auditor of a company under Section 226 of the Companies Act 1956 can be appointed auditor of these nationalised banks also The remuneration of the auditors is fixed by the bank in consultation with the Central Government

Every auditor is to be supplied with a copy of annual balance sheet and profit and loss account and a list of all books kept by the nationalised bank. The auditor is required to examine the profit and loss account and the balance sheet with the vouchers and accounts relating thereto The auditor has rights to have access to the books, accounts and other documents of these banks He may, at the expense of the bank, employ accountants or other persons to assist him in investigating such accounts. He may, as required, examine any officer or employee of the bank

The report has to be submitted by the auditor to the Central Government The report must state:

1 whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory ,

2 whether or not the transactions of the bank, which have come to his notice, have been within the powers of the bank ,

3 whether or not the returns received from the officers and branches of the bank have been found adequate for the purpose of his audit ,

4 whether the profit and loss account shows a true balance of profit or loss for the period covered by such account . and

5 any other matter which he considers should be brought to the notice of the Central Government.

The auditor will have to verify, sign and transmit the audit report in the prescribed manner He will have also to forward a copy of the audit report to the bank and to the Reserve Bank of India

The balance of the profits of then nationalised bank would have to be transferred to the Central Government It has been provided in Section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act that "after making provisions for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and all other matters for which provision is necessary under any law or which are usually provided for by banking companies", the profits have to be transferred to the Central Government

SPECIMEN OF AUDIT REPORT OF NATIONALISED BANKS

1 We have audited the attached Balance Sheet of . Bank as at and also the Profit and Loss Account of the Bank for the year ended on that date annexed thereto in which are incorporated the returns of branches audited by us, Branches audited by other auditors, and the unaudited returns in respect of branches not visited by us, for the exclusion of which branches from audit, concurrence of the Reserve Bank of India was obtained

2 The Balance Sheet and the Profit and Loss Account have been drawn up in Forms A and B respectively of the Third Schedule to the Banking Regulation Act, 1949 Accordingly they disclose such matters as were required to be disclosed in the case of banking companies prior to nationalisation, by virtue of the provisions of the said Act as read with the provisions of the Companies Act, 1956. Subject to the limitations of such disclosure and on the basis of the audit indicated in the first paragraph, we report that—

1. In our opinion and to the best of our information and according the explanations given to us and as shown by the books of the Bank
   (a) the Balance Sheet read with the notes thereon is a full and fair Balance Sheet containing the necessary particulars and it is properly drawn up so as to exhibit a true and fair view of the affairs of the Bank as at ,
   (b) the Profit and Loss Account shows a true balance of profit for the period covered by the Account
2. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit and have found them to be satisfactory
3. The transactions of the Bank have which have come to our notice have been within the powers of the Bank.

4. The returns received from the offices and branches of the Bank have been found adequate for the purposes of audit

Auditors

AUDIT OF REGIONAL RURAL BANKS

The Central Government has been establishing regional rural banks from 2nd October, 1975 For this, Regional Rural Banks Act was passed in 1976 which deemed to have come into effect from 26th September 1975 This Act contains provisions for the regulation of the working of the regional rural banks in the country These banks have been established with a view to provide credit facilities to the rural areas

These banks are set up by the Central Government, but under the sponsorship of an existing bank The sponsoring bank implies an existing bank which agrees to subscribe to its share capital, recruit, and train the personnel for the first five years and provide managerial and financial assistance as desired

The limits for the authorised and issued capital of such banks has been prescribed under Section 5 and 6 of the Act Under Section 7 of the Act, the shares of a regional rural bank shall be deemed to be approved securities under the Indian Trusts Act, 1882

It may also be pointed out that certain provisions of the Banking Regulation Act, 1949 also apply to these regional rural banks, specially Sections 10, 13 to 15, 17, 19 to 21, 23 to 28, 29, 31, 34 and 46.

The regional rural banks shall carry on and transact the business of banking and may undertake under Section 6 (1) the following types of business

(i) the granting of loans and advances, particularly to small and marginal farmers and agricultural labourers, whether individually or in groups, and to cooperative societies, including agricultural marketing societies, agricultural processing societies, co operative farming societies, primary societies, agricultural credit societies or farmers service societies, for agricultural purposes or agricultural operations or for other purposes connected therewith ; and

(ii) the granting of loans and advances, in particular to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry or other productive activities, within the notified area

Every regional rural bank is required to close its books of account on 31st December every year, according to Section 19 of the Act It is also required to appoint an auditor, with the approval of the Central Government, to audit its accounts The auditor will get such remuneration, as the regional rural bank may fix, with the

approval of the Central Government The qualification of an auditor is the same, as prescribed under Section 226 of the Companies Act, 1956

The powers of an auditor appointed by the regional rural bank are the same as available to the auditors of nationalised banks He would examine the balance sheet of the bank and consult all the same relevant vouchers for the same

The report of the auditor has to be submitted directly to the concerned regional rural bank The contents of the report are the same as prescribed for the nationalised banks, stated earlier

Section 20 of the said Act provides that the rural bank has to send to its shareholders, within 60 days from the date of closure of its accounting year, is a report as to its working and activities during the accounting year immediately preceding together with a copy of its balance sheet, profit and loss account, and the auditor's report.

A regional rural bank may declare dividend, under Section 21, out of its net profits after making due provision for the bad and doubtful debts, depreciation in assets, contribution to the staff and super-annuation funds, and all other matters for which provision has to be made under any law The usual provisions made by banking companies have also to be duly made

Section 22 of the Act, provides that a regional rural bank should be deemed to be a cooperative society for the purpose of the Income-Tax Act, 1961 or any other enactment for the time being in force relating to any tax on income, profits or gains.

The auditor has to be duly conversant with the above provisions of the Regional Rural Bank Act, 1976 and must see that they have been duly observed

THE THIRD SCHEDULE

FORM A

Form of Balance Sheet

Capital and Liabilities	Rs	Rs	Property and Assets	Rs	Rs
1 Capital (a)—			1 Cash		
Authorised capital Shares of Rs. each			In hand and with Reserve Bank		
Issued capital Shares of Rs each			Balances with other Banks		
Subscribed capital Shares of Rs each			2 Money at Call and Short Notice		
Amount called up at Rs per share			3 Bills discounted and purchased		
Less calls unpaid			4 Investments (stating mode of valuation) (f)		
Add forfeited shares			*i* Government Securities		
2 Reserve Fund & other Reserves			*ii*. Shares (classifying types & amount paid up)		
3 Deposits and other Accounts			*iii* Debentures		
i Fixed Deposits			*iv* Other Investments (to be classified)		
ii Saving Deposits			*v* Gold		
iii Current Accounts			5. Loans, advances, cash credits & overdrafts		
			i Debts considered good in respect of which the bank is fully secured		
			ii Debts considered good for which		

Capital and Liabilities	Rs	Rs	Property and Assets	Rs	Rs
4. Borrowing from other Banks			the bank holds no other security than the debtors' personal security		
i. Secured (stating nature of Security)			*iii* Debts considered good, secured by personal liabilities of one or more parties in addition to the personal security of debtors		
ii Unsecured			*iv* Debts considered doubtful or bad not provided for .		
5 Bills Payable			*v* Debts due by directors or officers of the bank either severally or jointly with other persons		
6. Bills for Collection being bills receivable as per contra			*vi* Debts due by cos or firms in which directors of the bank are interested as directors, partners, managing agents (or members in the case of private cos)		
7. Other liabilities (c)			*vii* Maximum total amount of loans made at any time during the year to directors or managers or officers of the Company (ff)		
8. Acceptances, endorsements and other obligations as per contra .			*viii* Maximum total amounts of loans granted during the year to cos or firms in which the directors of the bank are interested (ff)		
9 Profit and Loss ...			*ix* Due from banks		
10 Contingent Liabilities (d)			6 Bills for collection being bills receivable as per contra . .		

			7. Acceptances, endorsements and other obligations as per contra		
			8 Premises less Depreciation (g)		
			9 Furniture and Fixtures (g)		
			10 Other Assets including Silver (h)		
			11 None-banking Assets (stating mode of valuation (i)		
			12 Profit and Loss ..		
Total Rs			Total Rs		

NOTES

(*a*) Capital—

(*i*) The various classes of capital, if any, should be distinguished

(*ii*) Shares issued as fully paid up pursuant to any contract without payments being received in cash should be stated separately.

(*iii*) Where circumstances permit, issued and subscribed capital and amount called up may be shown as one item, *e g* , Issued and Subscribed Capital Shares of Rs .. paid up

(*iv*) In the case of banking companies incorporated outside India the amount of deposit kept with the Reserve Bank of India under Section 11 (2) of the Banking Companies Act, 1949, should be shown under this head , the amount, however, should not be extended to the other column

(*b*) deleted

(*c*) Under this heading may be included such items as the following pension or insurance funds, unclaimed dividends, advance payments, and unexpired discounts, liabilities, to subsidiary companies and any other liabilities

(*d*) These should be classified under the following categories —

(*i*) Claims against the banking company not acknowledged as debts

(*ii*) Money for which the banking company is contingently liable showing separately the amount of any guarantee given by the banking company on behalf of directors or officers.

(*iii*) Arrears of cumulative preference dividends.

(*iv*) Liability on Bills of exchange re-discounted.

(*v*) Liability on account of outstanding forward Exchange Contracts

(*e*) deleted.

(*f*) Where the value of the investments shown in the outer column of the balance-sheet is higher than the market value, market value should be shown separately in brackets

(*ff*) Maximum total outstanding balance in all such accounts as a unit on any day during the year should be given under this heading

(*g*) Premises wholly or partly occupied by the banking company for the purposes of business should be shown against "Premises less depreciation" In the case of fixed capital expenditure, the original cost, and addition thereto and deductions therefrom during the year should be stated, as also the total depreciation written off Where sums have been written off on a reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction should show the reduced figures with the date and amount of the reduction made Furniture, fixtures and other assets which have been completely written off need not be shown in the balance-sheet

(*h*) Under this heading may be included such items as the following, which must be shown under headings suitably described preliminary, formation and organisation expenses, development expenditure, commission and brokerage on shares, interest accrued on investments but not collected, investments in shares of subsidiary companies and any other assets

(*i*) Value shown shall not exceed the market value and in cases where the market value is not ascertainable, the estimated realisable value

FORM B

FORM OF PROFIT AND LOSS ACCOUNT

For the year ended .

Expenditure	Rs.	Income	Rs
Interest paid on Deposits		Interest and Discount	
Salaries and Allowances		Commission, Exchange and Brokerage	
Directors' Fee & Allowances*		Rents	
Local Committee Members' Fees and Allowances		Profit made on sale of investments and other assets	
Provident Fund		Profits made on revaluation of investment and other assets	
Rent, Taxes, Insurance, Lighting, etc		Income from non banking assets	
Law Charges		Other receipts	
Postage, Telegrams and Stamps		Loss, if any	
Auditor's Fees			
Depreciation			
Repairs			
Stationery, Printing, Advertisement, etc.			
Loss from Non-banking Assets			
Other Expenditure			
Balance of Profit			
Total		Total	

*Showing separately salaries and allowances to managing director or manager

QUESTIONS

1 In what forms of business a banking company can engage itself ? Also describe the restrictions on the business of such company

2 Describe the main features of internal check suitable for a banking company

3 Discuss in detail, the special features of a bank audit

4 Give specimen to the auditor's report to the members of a banking company

5 Describe the position regarding the audit of nationalised banks Give specimen of the auditor's report of a nationalised bank

6 Describe briefly about the audit of the regional rural banks-

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Audit of Insurance Companies

Companies dealing in insurance business may broadly be classified into the life insurance companies and general insurance companies. The life insurance companies deal in the life insurance business in which case the policy amount is payable to the insured on the happening of his death or in some cases after the maturity of some fixed period or his death, whichever is earlier The general insurance companies deal mainly in three classes of insurance business, namely, fire insurance, marine insurance and miscellaneous insurance In case of fire insurance, the policy amount becomes payable to the insured if he suffers a loss on account of his properties catching fire In case of marine insurance, the insurance company agrees to pay the policy amount to the insured in case his property or the ship suffers damages while on sea The miscellaneous insurance covers almost all types of risks to which a human being is exposed, *e g* motor-car insurance, accident insurance, insurance against theft etc

Prior to the enactment of Life Insurance Corporation Act, 1956, all the insurance companies were governed by The Insurance Act, 1938 The Life Insurance Corporation Act, 1956 provided for the nationalisation of all the life insurance businesses in India and its transfer to the Life Insurance Corporation of India, established on 1st September, 1956 Now this Corporation has exclusive privilege of carrying on life insurance business in India under Section 30 of the Act

The general insurance business was nationalised by the Government and for the purpose, the General Insurance Business (Nationalisation) Act was passed in 1972 Accordingly, the General Insurance Corporation was established on November 22, 1972 to carry on the general insurance business The existing companies have been merged and four insurance companies have been set up, which will carry on general insurance business operations under the supervision of the General Insurance Corporation Thus, the General Insurance Corporation along with the four companies have now exclusive rights to carry on such business

In this chapter, we shall deal with the audit of the general insurance business only The audit of life insurance business is not discussed as, with the nationalisation of life insurance business, it is carried on according to the rules laid down by the Central Government on the advice of the Comptroller and Auditor-General of India.

An auditor of an insurance Company should be familiar with the relevant provisions of the Insurance Act, 1938 and the Insurance Rules, 1939 which are discussed below

Applicability of Companies Act. Section 117 of the Act provides that in matters not otherwise specifically provided for by the insurance Act, the provisions of the Companies Act, 1956 will be applicable to the insurance companies

Deposits Every company carrying on insurance business in India shall have to deposit and keep deposited a prescribed amount with the Reserve Bank of India on behalf of the Central Government (Section 7) This deposit amount may be either in cash or in approved securities The estimation of the value of the approved securities will be determined by the Reserve Bank on the basis of the market value of those securities on the day of deposit Its decision, in this respect, shall be final (Section 120)

The prescribed amounts of deposit are as under :—

(*a*) For Fire Insurance business only	Rs.	1,50,000
(*b*) For Marine Insurance business only		1,50,000
(*c*) For Miscellaneous Insurance business only		1,50,000
(*d*) For Fire, Marine and Miscellaneous Insurance business combined		3,50,000
(*e*) For any two (*a*) Fire, (*b*) Marine and (*c*) Miscellaneous Insurance business		2,50,000
(*f*) Where the business is that of Marine insurance only and relates exclusively to country craft or its cargo or both.		10,000

It is provided that a deposit made in cash shall be held by the Reserve Bank of India to the credit of the insurer and shall be returnable the insurer in cash in any case in which under the provisions of the Act a deposit is returnable Any interest accruing, due and collected on securities deposited shall be paid to the insurer, subject only to deduction of the normal commission chargeable for the realisation of interest [Section 7 (8)] Provisions for reservation and refund of deposits are also given under Sections 8 and 9 respectively.

Management An insurance company cannot appoint a managing agent for the conducts of its business (Section 32) Similarly its business cannot be managed by a company or a firm It cannot be managed by a person employed as manager or officer or in any capacity, whose remuneration or part thereof takes the form of commission or bonus in respect of the general insurance business of the company (Section 31-A). Payment of excessive remuneration is also prohibited and the Central Government is empowered to restrict such payments (Section 31-B). These provisions do not apply to Central Insurance Corporation of India

Every insurer shall, before the close of month following every year, submit to the Controller a statement in the prescribed form

showing the remuneration paid, whether by commission or otherwise, to any person in cases where such remuneration exceeds the sum of Rs 5,000 in that year Similarly, where any person, not being a chief agent, principal agent or special agent is in receipt of remuneration exceeding Rs 5,000 in any year, the Controller may require the insurer to submit certified copies of the agreement entered into between the insurer and any such person [Section 31-B (3)]

Maintenance of Registers Every company is required to maintain two registers (*i*) Register of Policies, and (*ii*) Register of Claims (Section 14) In the Register of Policies shall be entered in respect of every policy issued by the insurer, the name and address of the policy-holder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice

Similarly, in the Register of Claims will be entered every claim made together with the date on which the claim was made, the name and address of the claimant and the date on which the claim was discharged or in the case of a claim which is rejected, the date of rejection and the grounds therefor

Commission Section 40 prohibits the payment by way of commission or otherwise for soliciting or procuring insurance business to any person except an insurance agent Section 40A provides limitation of expenditure on commission It provides that no person shall pay or contract to pay to an *insurance agent* by way of commission or remuneration a sum exceeding—

(*i*) where the policy relates to fire or miscellaneous insurance, *fifteen per cent* of the premium payable on the policy , and

(*ii*) where the policy relates to marine insurance, *ten per cent* of the premium payable on policy

Similarly, no person shall pay or contract to pay to a *principal agent* by way of commission or remuneration a sum exceeding—

(*i*) where the policy relates to fire or miscellaneous insurance, *twenty per cent* of the premium payable on the policy , and

(*ii*) where the policy relates to marine insurance, *fifteen per cent* of the premium payable on the policy

The Central Government is empowered to authorise payment of commission exceeding the limits given above to a principal agent of an insurer incorporated to domiciled out of India, if he carries out in his own office duties on behalf of the insurer which would otherwise have been performed by the insurer

Prohibition of Rebates Payment of rebates of the whole or part of the commission or of the premium directly or indirectly is prohibited (Section 41) Neither a person can pay such rebates nor can he receive them

Prohibition of Loans. No insurance company can grant loans

or temporary advances either on hypothecation of property or on personal security or otherwise (Section 29) Such prohibition is applicable for loans to any director, manager, actuary, auditor or officer if the insurer is a company if the insurer is a firm, to any partner therein It is also applicable to any other company or firm in which any such director, manager, actuary, officer or partner holds the position of a director, manager, managing agent, actuary, officer or partner The loans, however, may be granted either on mortgage or otherwise to agents to the extent of commission earned by them in the year immediately preceeding the grant of the loans The insurer may give loans to banking company

Investments Section 27(B) of the Insurance Act provides that no insurance company carrying on general insurance business can invest or keep invested any part of its assets otherwise than in any of the approved investments or in other investments which satisfy certain conditions or in certain prescribed assets which are deemed to be approved investments for the purpose of this section

A general insurance company can invest any part of its assets in investments other than the approved investments provided that (*i*) the total amount of all such investments does not exceed 25 per cent of its assets and (*ii*) the making or the continuance of the investment is with the consent of all the directors, present at meeting and eligible to vote, special notice of which has been given to all directors, then in India All such investments, including investments in which any director is interested, must be reported without delay to the Controller with full details of the investments and the extent of any director's interest in any such investment

Limits of Investments in one Company An insurance company cannot invest or keep invested any part of its assets in the shares of any one banking company or of any one investment company more than (*i*) 10 per cent of its assets or (*ii*) 2 per cent of the subscribed share capital and debentures of the banking company or investment company concerned, whichever is less. It cannot invest or keep invested any part of its assets in the shares or debentures of any one company other than banking company or investment company more than (*i*) 10 per cent of its assets, or (*ii*) 10 per cent of the subscribed share capital and debentures of the company, whichever is less

Where an investment is in partly paid up shares, the uncalled liability on such shares shall be added to the amount invested, for the purpose of finding out whether such investment exceeds the limits referred to above However, a company can subscribe to the right shares notwithstanding the limits specified above, provided the existing shares against which such shares are issued, satisfy certain conditions These limits do not apply to an investment made by an insurance company in the shares of any other insurance company carrying on insurance business in India

It may be pointed out that these insurance company cannot invest or keep invested any part of its assets in the shares or debentures of any private company

Limits of Deposits with one Banking Company An insurance company cannot keep more than 10 per cent of its fixed deposit or current deposit, or partly in fixed deposit and partly in current deposit, with any one banking company or any one co-operative bank. It is, however, provided that in applying this limit, all the premium credited during the preceding sixty days, and the amounts deposited, during the preceding thirty days for payment of claims or out of re insurance recoveries, should be excluded

Restrictions on Management Expenses There are provisions for the limitations of the management expenses of general insurance company No company can spend in any calendar year as expenses of management including commission or remuneration for procuring business an amount in excess of the prescribed limits (Section 40C) If excess amount has been spent by way of such expenses, such excess will be allowed if it is within such limits as may be fixed in respect of that year by the Controller of Insurer after consultation with the Executive Committee of the General Insurance Council

Every insurance company shall also incorporate in the revenue account a certificate duly signed by the chairman and two directors and by the principal officer of the insurer, and by an auditor certifying that all expenses of management wherever incurred, whether directly or indirectly, in respect of the business have been fully debited in the revenue account as expenses

Rule 17E of the Insurance Rules, 1939 also contains provisions with regard to the limitations of expenses of the management in general insurance business Rule 17F mentions the provisions in connection with the Head Office expenses

Power of the Central Government Section 114 of the Insurance Act empowers the Central Government to make rules regarding various matters connected with insurance business Under Section 23 of the General Insurance Business (Nationalisation) Act, 1972 also, the Central Government has the power to issue directions to the General Insurance Corporation of India and every other insurance company in regard to matters of policy involving public interest

Directions by G I C Under section 18 (1) of the General Insurance Corporation of India can issue directions to general insurance companies regarding the conduct of their business The G I C can advise such companies regarding standards of conduct, sound business practices, control of expenses and investment of funds

Insurance Agents For the purpose of soliciting or procuring insurance business, the Controller or an officer authorised by him in this behalf shall, in the prescribed manner and on payment of the prescribed fee, issue to any person a license to act as an insurance agent (Section 42). But the application for this has to made in the prescribed manner. The following persons, however, cannot be granted license for the purpose

(*a*) a minor,

(b) a person of unsound mind ,

(c) a person found guilty of criminal misappropriation or criminal breach of trust or cheating ,

(d) a person found guilty of or having participated in or connived at any fraud, dishonesty or misrepresentation in the course of any judicial proceeding relating to any policy of insurance or the winding up of an insurance company or in the course of an investigation of the affairs of an insurer

Register of Insurance Agents Every insurer and every person who, acting on behalf of an insurer, employs insurance agents shall maintain a register showing the name and address of every insurance agent appointed by him the date on which his appointment began and the date on which the appointment ceased (Section 43)

Restrictions on Dividends and Bonuses Under Section 49, no insurer can utilise directly or indirectly any portion of the insurance fund except a surplus shown in the valuation Balance Sheet for the purpose of declaring or paying any dividend to shareholders or any bonus to policy-holders or of making any payment in service of any debentures It cannot increase such surplus by contributions out of any reserve fund or otherwise unless such contributions have been brought in as revenue through the revenue account, on or before the date of the valuation Exception is there in connection with the reserve fund when it is made up solely of transfers from similar surpluses disclosed by valuations

Payments made out of any such surplus in service of any debentures shall not exceed 50 per cent of such surplus including any payment by way of interest on the debentures The interest paid on the debentures shall not exceed 10 per cent of any such surplus except when the interest paid on the debentures is offset against the interest credited to the fund in deciding the interest basis adopted in the valuation disclosing the aforesaid surplus

Section 20 of the General Insurance Business (Nationalisation) Act provides that each general insurance company will distribute dividends out of its profits after making provisions for bad and doubtful debts, depreciation in assets, provident, super annuation, welfare and other funds, debts due to Government and all other matters for which provision is necessary under any law or which are usually provided for by insurance companies

Books to be kept by Insurers established outside India Every insurer having his principal place of business or domicile outside India shall keep at his principal office in India such books of account, registers and documents as will enable the submission of accounts, statements and abstracts which he is required under this Act to furnish to the Controller. He shall also furnish to the Controller on or before the last day of January every calendar year a certificate from an auditor to the effect that the said books of account, registers and documents are being kept as required at the principal office of the

insurer in India (Section 64)

Separation of Accounts and Funds Section 10 provides for the separation of accounts and funds If an insurance company carries on business of more than one class, it is required to keep a separate account of all receipts and payments in respect of each such class of insurance business In case miscellaneous insurance business is being carried on by the company, it is to maintain separate account of all receipts and payments in respect of each sub-class of business as may be prescribed in this behalf The Controller of insurance, however, has the power to waive this provision

Accounts and Balance Sheet According to Section 11 of the Act, every insurance company shall prepare a Balance Sheet in the form set forth in Part II of First Schedule and in accordance with the regulations contained in Part I of that Schedule Similarly, it shall prepare a Profit and Loss Account in accordance with the regulations contained in Part I of that Schedule, except where the insurer carries on business of either life insurance or fire insurance or marine insurance only and no other business Separate revenue accounts shall have to be prepared in respect of each class or sub class of the insurance business

An auditor should very carefully note down the provisions in respect of forms and contents of the accounts of the insurance company If he is not thoroughly familiar with such provisions, he will not be able to perform his duties well

The various forms given in the First Schedule and the Second Schedule are reproduced at the end of the chapter

Authentication of Accounts and Filing of Returns The accounts and statements shall be signed by the insurer, or in the case of company by the chairman, if any, and two directors and the principal officer of the company In case of a firm, they have to be signed by two partners of the firm They shall be accompanied by a statement containing the names, descriptions and occupations of, and the directorship held by, the person in charge of the management of the business during the period to which such accounts and statements refer and by a report on the affairs off the business during the period.

The audited accounts and the statements shall be printed and four copies thereof shall be furnished as returns to the Controller within the prescribed limits (Section 15)

Special points in Audit of Insurance Companies Every insurance company shall get its Balance Sheet, Profit and Loss Account, Revenue Account and Profit and Loss Appropriation Account in respect of all the insurance business transacted by it in India, audited by an auditor annually under the Companies Act, 1956

The auditor shall have the powers of exercise the functions vested in and discharge the duties and be subject to the liabilities and penalties imposed on, auditors of companies by Section 227 of the Companies Act, 1956.

It will not be possible for an auditor to check all the transactions of an insurance company in detail and therefore, he has to depend upon the internal check and control applied by the company to a great extent Having enquired about them, he should decide about the extent of the checking of the accounts At the same time, he must keep in mind the various provisions of the Insurance Act, 1938 and see that they are duly observed Then he should proceed as follows

(*i*) Vouch the premiums received with the copies of the insurance policies, cover notes or premium receipts Check the premium receipts with the Register of Policy for direct as well as re-insurance business Check total income from premiums with the Premium Register Check all the adjustments in connection with the premiums, *i e*, premiums received in advance, outstanding premiums and premiums paid for re-insurance For extra premiums, vouch with the premium receipts issued to the insured For the refunds of premiums vouch with the refund vouchers See that no rebate on premium has been given as it is prohibited under Section 41

(*ii*) Check the receipts from interest and dividends and see that they have been duly collected up-to-date Check that outstanding interest and dividends have been duly brought into account

(*iii*) Check the Register of Claims in connection with the claims paid or payable by the company Vouch the claims paid with reference to the Register of Claims, the survey report, receipts given by the insured and the copy of policy Check the circular from the company concerned together with the survey report in connection with the re-insurance claims Check the money received from the re insurance carefully Check that all the adjustments for the claims outstanding and payable have been duly made in the books

(*iv*) Vouch the commission payments with the commission voucher and the receipts given by the agents and agents' accounts See that the rate of commission has not exceeded the prescribed limit For further checking, reconcile the premiums received on such business Check that all the outstanding commissions have been duly adjusted in the accounts Check the re-insurance commission received and paid with the receipts, statements of account and Borderaux received from the re-insurance companies and treaties

(*v*) Examine the expenses of the management very carefully and see that provisions of the Act in this connection have been duly observed See that such expenses have been charged to Revenue Account only, duly classified Check that the common expenses have been allocated between various departments (Fire, Accident, Marine and General) Ensure that such allocation is based on accounting principles and made reasonably and equitably.

(*vi*) Check all the re-insurances in detail. They may be either ceded or accepted They may be ceded if a part of the risk is passed on to other companies In that case he should examine the treaties with the ceding companies Vouch all payments and recoveries care-

fully See that all the outstanding liability or asset on this account is duly provided for Ensure that in Revenue Accounts, commission on reinsurance accepted and ceded has been disclosed separately on its debit or credit side as the case may be Some treaties incorporate a provision entitling the ceding company to profit commission on the profits realised by each of the reinsuring companies from its share of the treaty If it is so, the auditor should see that provision is made in the accounts for outstanding profit commission

(*vii*) Verify all the investments made and the cash balances Investment lodged with the Reserve Bank should be verified with the Reserve Bank's certificate. Investments lodged with other banks should be verified with the safe custody receipts and bank certificates Ensure that the market value of the investments has been correctly ascertained Similarly, verify the cash balances very carefully Reconnicle the bank balances with the bank certificates confirming them It is to be noted that an auditor of an insurance company has to state in his report that he has verified the cash and bank balances, investments and the securities relating to loans

(*viii*) Scrutinise carefully the outstanding branch and agency balances to ascertain that they are recoverable See that adequate provisions has been made against all doubtful accounts Check the recoveries during the subsequent period carefully for his purpose For large balance see that the client has obtained confirmation certificates

(*ix*) See that adequate amount has been set aside for reserve for unexpired risks Normally, it is to be noted that a reserve of 40 per cent of the premium income would be adequate but for marine insurance it should be more

(*x*) Ensure that all the contingent liabilities have been duly ascertained and properly disclosed in the Balance Sheet as required

(*xi*) See that the provisions of Code of Conduct have been duly observed as it is required to be observed by the general insurers in India

(*xii*) See that the annual accounts of the insurer have been prepared in accordance with the prescribed forms and the regulations for their preparations have also been duly observed while preparing them

Auditor's Report An auditor has to submit his report to the shareholders of the insurance company It may be, more or less, in the following form

"We have audited the annexed Balance Sheet of the . Company, Limited, as at . . 19 , and the Revenue Accounts, the Profit and Loss Account and the Profit and Loss Appropriation Account of the company for the year ended upon that date in which are incorporated the Returns from various Branches and Agencies

In accordance with the provisions of the Insurance Act, 1938 read with the provisions of the Companies Act, 1956 the Balance

Sheet, the respective Revenue Accounts, the Profit and Loss Account, and the Profit and Loss Appropriation Account are not required to be and are not drawn up in accordance with the Sixth Schedule to the Companies Act 1956 The accounts are, therefore drawn up in conformity with Form A of the Part II of the First Schedule. Form B & C of Part II of the Second Schedule and Form F of Part II of the Third Schedule to the Insurance Act 1938 We report that —

1. We have obtained the information and explanations which we have required
2. In our opinion, the annexed Balance Sheet Revenue Accounts, Profit and Loss Account and Profit and Loss Appropriation Account are drawn up in conformity with the law
3. Such Balance Sheet exhibits a true and fair view of the state of the company's affairs according to the best of our information and the explanations given to us and as shown by the books of the company
4. In our opinion, the books of account have been kept by the company for the year under report as required
5. We have verified the cash balances and investments by actual inspection or by the production of certificates or vouchers, and have also verified the securities relating to the loans.
6. All expenses of management incurred in respect of the general insurance business have been fully debited as expenses in the respective Revenue Accounts

Auditors

FIRST SCHEDULE—PART II
FORM A
FORM OF BALANCE SHEET

	Liabilities	Rs.		Assets	Rs.
1	Shareholder's Capital		1	Loans	
2	Reserve or Contingency a/cs (*a*)			(*i*) On Mortgages of Property	
	Investment Reserve Account			(*ii*) On security of municipal and other public rates	
3.	Profit & Loss Appropriation Account Balance			(*iii*) On Stocks and Shares	
4	Balance of Funds and Accounts			(*iv*) On insurer's policies within their surrender values	
	Fire Insurance Business a/c			(*v*) On personal security	
	Marine Insurance Business a/c			(*vi*) To subsidiary cos (f)	
	Miscellaneous Insurance Business account (*m*)			(*vii*) On reversions and life interests	
	Other Accounts (to be specified (*i*)		2	Investments	
	Pension & Superannuation a/c (*b*)			(*i*) Deposits with Reserve Bank of India	
5	Debenture Stock			(*ii*) Government Securities	
6	Loans and Advances (*c*)			(*iii*) Municipal Securities	
7	Bills Payable (*c*)			(*iv*) Bonds, Debentures and Stocks whereon interest is guaranteed by Government	
8.	Estimated Liability in respect of outstanding Claims whether due or intimated (*d*)			(*v*) Railway Securities	
				(*vi*) Securities of Cos	
				(*vii*) Holding in subsidiary companies	
				(*viii*) Ground Rents and Rent Charges	
9	Annuities due and unpaid (*d*)		3	Agents' Balances	
10	Outstanding Dividends				

11	Amount due to other Persons or Bodies carrying Insurance Business (c)	4	Outstanding Premiums (g)/(d)
12.	Sundry Creditors (c)	5	Interest, Dividends & Rents Outstanding (d)
13	Other Sums owing by Insurer (c)	6	Interest, Dividends and Rents Accruing but not due (d)
14	Contingent Liabilities (to be specified) (e)	7	Amounts due from other persons or bodies carrying on insurance business (h)
		8	Sundry Debtors (i)
		9	Bills Receivable
		10	Cash
			(i) At Banks on Deposit Account
			(ii) At Banks on Current Account and in Hand
			(iii) At Call and short Notice (j)
		11	Other Accounts (to be specified) (k)

N B It is a simplified version of Form A

NOTES

(a) The Reserves or Contingency Accounts must be separately stated

(b) If the insurer has not full and unrestricted control of the assets constituting the Pension or Superannuation Accounts, either those Accounts and the assets and liabilities relating thereto must be omitted from the balance-sheet or the assets of which the insurer has not such control must be clearly indicated on the face of the balance-sheet

(c) If the insurer has deposited security as cover in respect of any of these items, the amount and nature of the securities so deposited must be clearly indicated on the face of the balance sheet.

(d) These items are or have been included in the corresponding items in the Revenue or Profit and

Account. Outstanding and accruing interest, dividends and rents must be shown after deduction of income-tax or the income-tax must be provided for amongst the liabilities on the other side of the balance-sheet

(*e*) Such items as amount of liability in respect of bills discounted, uncalled capital of subsidiary companies, uncalled capital of other investments, etc , must either be shown in their several categories under the heading ' Contingent Liabilities" or the appropriate items on the assets side must be set out in such details as will clearly indicate the amount of the uncalled capital

(*f*) As respects life and annuity business full particulars of holding in and loans to subsidiary companies must be stated, giving the name of each company, the number and description of each class of shares held, the amounts paid up thereon and the value at which the holdings in each company stand in the balance sheet

(*g*) Either this item must be shown net or the commission must be provided for amongst the liabilities on the other side of the balance-sheet

(*h*) The aggregate amount owing by a subsidiary company or subsidiary companies is to be shown separately from all other assets and the aggregate amount owing to a subsidiary company or subsidiary companies is to shown separately from all other liabilities

(*i*) Amount due from directors and officers must be shown separately

(*j*) No amount must be entered under his heading unless fully secured If not fully secured, the amounts must be included under the heading "Sundry Debtors"

(*k*) Under this heading must be included such items as the following which must be shown under separate heading suitably described Office-furniture, goodwill, preliminary, formation and organisation expenses, development expenditure account, discount on debentures issued, other expenditure carried forward to be written off in future years, balance being loss on Profit and Loss Appropriation Accounts etc The amount included in the balance sheet must not be in excess of cost

(*l*) Under the head, "Other accounts, if any (to be specified)", on the left hand side, fines realised from the staff and their contribution towards the provident fund, if any, should be shown under separate sub heads

(*m*) Where the insurer is required to maintain a separate account in respect of any sub-class of miscellaneous insurance business this heading is to be split up accordingly

(THE FIRST SCHEDULE)

FORM AA

Classified Summary of Assets in India of . Company on ... 19 ....

Class of Asset	Book value	Market value	Remark
(1) Government of India Securities	Rs	Rs	
(2) Indian State Government Securities			
(3) Indian Municipal Port and Improvement Trust Securities including Debentures			
(4) Debentures of Indian Railways.			
(5) Guaranteed and Preference Shares of Indian Railways			
(6) Annuities of Indian Railways			
(7) Ordinary Shares of Railways in India			
(8) Other Debentures of concerns in India			
(9) Other Guaranteed and Preference Shares of concerns in India			
(10) Other Ordinary Shares of concerns in India			
(11) Loans on the Company's policies effected in India and within their surrender value			
(12) Loans on Mortgage of property in India			
(13) Loans on Personal Security to persons domiciled and resident in India			
(14) Other loans granted in India (particulars to be stated)			
(15) Land and House property in India			
(16) Cash on deposit in banks in India			
(17) Cash in hand and on the current account in banks in India			
(18) Agents' balances and outstanding premiums			
(19) Interest, dividends and rents either outstanding or accrued but not due			
(20) Other assets in India (to be specified).			

(THE SECOND SCHEDULE)

Part II—*Forms*

FORM B

Form of Profit and Loss Account

Profit and Loss Account of . . ..for the year ended .. 19 . ...

	Rs np		Rs np
Indian (Central) Taxes on the Insurer's Profits (not applicable to any particular Fund or Account)* ..		Interest, Dividends and Rents (not applicable to any particular Fund or Account) Rs Less —Income tax thereon Rs ——	
Expenses of Management (not applicable to any particular Fund or Account)*		Profit on realisation of Investment (not credited to Reserves or any particular Fund or Account)	
Loss on Realisation of Investment(not charged to Reserves or any particular Fund or Account)		Appreciation of Investment (not credited to Reserves or any particular Fund or Account)	
Depreciation of Investment (not charged to Reserves or any particular Fund or Account)		Profit transferred from Revenue Account (details to be given) .	
Loss transferred from Revenue Accounts (details to be given)		Transfer Fees	
Other Expenditure to be specified)		Other Income (to be specified) ...	
Balance for the year carried to Appropriation Account		Balance being loss for the year carried to Appropriation Account	

*If any sum has been deducted from this item and entered on the assets side of the balance-sheet, the amount must be shown separately.

FORM C

Form of Profit and Loss Appropriation Account

Profit and Loss Appropriation Account of for the year ended 19 .

	Rs np		Rs np.
Balance being loss brought forward from last year		Balance brought forward* from last year Rs	
Balance being loss for the year brought from Profit and Loss Account (as in Form B)		Less- Dividends since paid in respect of last year (to be specified and if "free of tax" to be so stated) Rs	
Dividends paid during the year on account of the current year (to be specified and if "free of tax" to be so stated)			
Transfers to any particular Funds or Accounts (details to be given)		Balance for the year brought from Profit and Loss Account (as in Form B)	
Balance at the end of the year as shown in the Balance-Sheet		Balance being loss at the end of the year as shown in the Balance-Sheet	

Note—This item may be shown on the other side of the account if preferred.

(THE THIRD SCHEDULE)

FORM F

Form of Revenue Account Applicable to Fire Insurance Business, Marine Insurance Business and Miscellaneous Insurance Business

Revenue Account of   for the year ended   19
in respect of Business

		Rs			Rs.
Claim under Policies, less Reinsurances (*a*) (*d*)			Balance of Account at beginning of the year		Rs
Paid during the year	Rs		Reserve for unexpired Risks		
Total estimated liability in respect of outstanding claims at the end of the year whether due or intimated	Rs		Additional Reserve (if any)	Rs	
	———			———	
	———		Premiums, less Re-insurances (*d*)	Rs	
Total			Interest, Dividends and Rents	Rs	
Less—Outstanding at the end of the Previous year (*b*)	Rs		Less—Income-tax thereon	Rs	
Commission on direct Business				———	
Commission on Re-insurances accepted			Commission on Re-insurances ceded		
Expenses of management (*c*)					
Bad Debts			Other Income (to be specified) (*e*)		
United Kingdom, Indian Dominion and Foreign Taxes			Loss transferred to Profit and Loss Account		
Other Expenditure (to be specified)			Transferred from Appropriation Account		
Profit transferred to Profit and Loss Account					
Balance of Account at the end of the year as shown in the Balance-sheet					

Reserve for unexpired Risks being per cent of premium income of year	. Rs		
Additional Reserve (if any)	Rs		
	Rs		Rs

NOTES

(*a*) This heading must include all expenses directly incurred in setting claims

(*b*) If in any year the claims actually paid and those still unpaid at the end of that in respect of the previous year or years are in excess of the amount included in the previous year's Revenue Account as provision for outstanding claims, then the amount of such excess must be shown in the Revenue Account

(*c*) If any sum has been deducted from this item and entered on the assets side of the balance-sheet the amount so deducted must be shown separately

(*d*) Where the account is furnished under the provisions of Section 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in India and claimants outside India, and for premiums derived from business effected in India and effected outside India must be given

(*e*) All the amounts received by the insurer directly or indirectly whether from this head office or from any other source outside India shall also be shown separately in the revenue account except such sums as properly appertain to the capital account

Where the account is furnished under the provisions of clause (*b*) of Sub section (2) of Section 16 of the Insurance Act, 1938, by an insurer to whom that section applies, separate figures for business within India and business out of India must be given against the items marked with an asterisk Against all other items the total amount for the business as a whole may be given

QUESTIONS

1 Describe briefly the provision of Insurance Act, 1938, which affect audit of an insurance company

2 Explain the main and special features of audit of an insurance company

3 Give a specimen of auditor's report of an insurance company

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Audit of Co-operative Societies

Various co-operative societies have been set up in the country for the benefit of their members In general, they are voluntary in nature and service to the members rather than profit-earning is the motive of such societies They are operating in various areas We have consumers' co-operatives, producers' co-operatives, co-operative marketing societies, manufacturing or processing co-operative societies, service co operative societies, co operative housing societies and the co-operative societies etc

The co operative societies are governed by a Central Act, namely, the Co-operative Societies Act, 1912 It contains various provisions for regulations and working of these societies This Act is applicable as such in many of the States of the country Some of the States have adopted it without any change and others have brought certain changes in it. In Maharashtra, West Bengal, Bihar, Orissa, and Tamilnadu, these societies are governed by specific legislations passed by the respective State

An auditor has to be quite familiar with the provisions of the particular Act governing the working of the society under audit However, he has to be familiar with the provisions of the Co-operative Societies Act, 1912 Some of the main provisions of the Act, as they effect the audit of the co-operative societies, have been briefly mentioned below

(*i*) *Registration of Co-operative Societies* Every co-operative society has to be registered under the Co-operative Societies Act, 1912 with the Registrar of the Co-operative Societies in Each State

(*ii*) *Liability* The liability of the members of the society may be limited or unlimited Section 4 of the said Act provides that unless the State Government, by general or special order, directs otherwise, (*a*) the liability of a society of which a member is a registered society shall be limited, (*b*) the liability of a society of which the objective is creation of funds to be lent to its members, and of which the majority of its members are agriculturists, and of which no member is a registered society, shall be unlimited.

(*iii*) *By-Laws* Each co-operative society is required to frame its own by-laws which have to be registered with the Registrar According to Section 11 of the Act, the amendment of the by-laws would

not be valid unless the same has been duly approved by the Registrar of Co-operative Societies

(*iv*) *Restrictions on shareholdings* If the liability of the members of a society is limited, no member, other than a registered society, can hold such portion of the share capital of the society subject to a maximum of one-fifth, as may be prescribed by the rules or shares of the society worth more than Rs 1,000 (Section 5)

(*v*) *Restrictions on Transfer of Shares* If the society has been registered with unlimited liability, its members cannot transfer any share held by them A member, however, can do so provided (*a*) he has held such share for not less than one year, and (*b*) the transfer or charge is made to the society or to a member of the society

(*vi*) *Restrictions on Loans* A registered co-operative society cannot make a loan to any person other than a member It can, however, give loans to another registered society, with the general or special sanction of the Registrar (Section 29)

(*vii*) *Restrictions on Borrowings* A co-operative society, if registered can accept deposits and loans from non-members only to such extent and under such conditions as may be provided in its by-laws or rules

(*viii*) *Exemption from Income-tax, Stamp Duty, and Registration Fees* Section 28 of the Act empowers the Central Government to exempt the society from payment of income-tax, stamp duty or registration fees

(*ix*) *Reserve Funds and Payment of Dividends* Every society is required to transfer at least 25 per cent of its net profits to its reserve funds under Section 33. Only the balance of the profits is available for distribution of dividends to its members However, a society with unlimited liability cannot distribute dividends unless permission has been obtained for the same from the State Government for the purpose.

(*x*) *Maintenance of Accounts* A State Government can frame rules, under Section 43 (h) of the said Act, prescribing the books and accounts to be kept by a co-operative society. Normally, the societies maintain receipts and disbursement accounts, the profit and loss account, and the balance sheet

(*xi*) *Audit of Accounts* According to Section 17 of the said Act, the Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in his behalf, the accounts of every registered society once at least in every year The audit would include examination of overdue debts, if any, and valuation of the assets and liabilities of the society

(*xii*) *Appointment of Auditor* The Registrar of the Co-operative Societies has been entrusted with the responsibility of appointing the auditor of a cooperative society Normally, he gets the accounts of a society audited through the departmental auditors. He may also

get them audited by a person who possesses stipulated qualifications and is duly enrolled in the panel prepared and maintained by the Registrar for the purpose

(*xiii*) *Rights and Duties of Auditor* The auditor of co-operative society has the rights of access at all times to all the books, accounts, papers, and securities of the society He may seek all necessary information from the officer concerned The duties of an auditor of a co-operative society are quite wide and onerous He has to find out and report irregularities and improprieties, if any He has to see that the provisions of the said Act, by laws and rules etc have been duly observed He should not simply satisfy himself with the balance sheet audit or verificatory audit of the society He should, in fact, undertake the performance audit of such societies, as far as possible

(*xiv*) *Matters to be specified in Report.* Various States have prescribed, through legislation, the matters to be specified in the report Thus, the form of audit report differs from State to State In case of Maharashtra State, for instance, it is required that the auditor should report about proper maintenance of books of account, the availability of the necessary information and explanations, and whether the profit and loss account and the balance sheet show the true and fair state of affairs of the society In that State, an auditor is also required to furnish the following

(*a*) particulars of all transactions which appear to be contrary to the provisions of the Act, the rules, or the by-laws of the society , (*b*) all sums which ought to have been but have not been brought in account by the society , (*c*) any material impropriety or irregularity in the expenditure or in the realisation of money due to the society , (*d*) any money or property belonging to the society, which appears to be bad or doubtful of recovery , and (*e*) any other matter specified by the Registrar in this behalf

SPECIAL POINTS IN AUDIT OF A COOPERATIVE SOCIETY

An auditor has to perform the audit of co-operative societies very carefully and should not simply be satisfied with the verificatory audit of their accounts It is quite necessary because in most of the cases, these societies are not managed by competent persons who may possess sufficient knowledge about recording the transactions and proper maintenance of books of account Moreover, several times, misappropriation of funds and different type of irregularities have been reported in case of these societies

An auditor should pay special attention to the following points

(*i*) He should examine the regulations of the society and various relevant provisions of the Co-operative Societies Act, 1912 He should be familiar with the rules framed by the State of Government He should fully note the by-laws of the society

(*ii*) He should find out thoroughly the internal control system as they operate in case of the society The discrepancies, if any, should be fully noted

(*iii*) He should vouch all cash received by way of share capital with reference to the Register of Members and copies of the receipts issued to them He should check the subscriptions of non members, if any, and see that they are within the rules

(*iv*) He should vouch receipts from deposits, if any, with the help of the copies of receipts issued and records in Cash Book therefor

(*v*) He should vouch the grants from the Government, if any, with reference to the letter authorising such grants He should see that the grants have been utilised for the purpose for which it was sanctioned

(*vi*) He should check the moneys borrowed from the banks or Central Co-operative Society from the Cash Book and with the correspondence and other related documents

(*vii*) All the payments should be vouched by him thoroughly with reference to the related vouchers He must see that there has been no irregularity in this connection

(*viii*) He should vouch the receipts from interests on loans granted with the help of copy of agreement related thereto and he should see that all the interests have been duly recorded in the books

(*ix*) He should cast the Cash Book and verify the cash in hand at the end of the financial year

(*x*) He should verify the investment and see that they have been made in accordance with prescribed rules He should inspect them also

(*xi*) He should verify the stock thoroughly

(*xii*) He should see that the reserve has been created with at least 25 per cent of the profits of the society

(*xiii*) He should examine the payment of dividends to the members thoroughly

(*xiv*) He should satisfy himself fully that the accounts have been prepared in accordance with the rules prescribed for them and they reflect the true and fair view of the State of affairs of the society

(*xv*) He should draft the report in accordance with the requirements of the Rules framed by the State Government concerned and or particular legislation for the same

QUESTIONS

1. Describe briefly main provisions of Co-operative Societies Act, 1912, which affect their audit.

2. Describe the special points in audit of a co-operative society

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Audit of Public Sector Undertakings

A large number of public sector undertakings has been set up in the country by the Central as well as State Governments There has been unprecedented and phenomenal growth of such undertakings in the country specially after attainment of independence in 1947 During 1950-51, there were only 5 Central Government undertakings with a mere investment of Rs 29 crores in them Their number increased to 159 with a total investment of Rs 15,602 crores as on March 31, 1979. Thus, today they occupy a pivotal role in the economic development of the country and, with persistent effort, they have been able to attain 'the commanding heights' of the economy Majority of these undertakings are giant in size and are engaged in production of basic and capital goods in the country Besides manufacturing goods, they are engaged in variety of activities employing large number of workers (about 18 71 lakh, as on March 31, 1979)

The audit of these undertakings, in a non-traditional way, is highly essential as huge public money has been invested in them That is why they have been made accountable to the public through the Parliament Unlike private undertakings, they are controlled by the Government, Parliament, the Committee on Public Undertakings, the various legal enactments and hosts of other agencies They draw the attention of the press and public very soon

SOME NOTABLE FEATURES AFFECTING AUDIT

These public sector undertakings differ from private sector undertakings in many ways and it is necessary to keep them in mind before actually undertaking the audit of such undertakings Some notable features are as follows

(*i*) These undertakings have been set up mainly in three forms, *viz* , departmental undertakings, statutory corporations and Government companies All these three forms differ substantially from the point of their establishment, operations and operational autonomy

(*ii*) Majority of these undertakings has been set up as Government companies under the Companies Act, 1956, just like any other company in the private sector These undertakings have been set up as private limited company but after seeking permission from the Government they have omitted writing "Pvt Ltd " These companies are governed by the provisions of the Companies Act

(*iii*) A few undertakings have been set up as departmental undertakings and carry on their operations as a department attached to certain ministry Their operational autonomy is quite limited as they are under the direct control of the Government

(*iv*) A few of these undertakings have also been set up as statutory corporations and for that purpose special statutes have been enacted in the Parliament and they are governed by the special Act For example, Life Insurance Corporation Act, 1956 was passed for the establishment of Life Insurance Corporation of India Similarly, the Air India, Indian Airlines, the Oil and Natural Gas Commission, Central Warehousing Corporation, and the Food Corporation of India have been set up as statutory corporations It is notable that certain companies have been styled as corporations even though they are Government companies Thus, the Fertilizer Corporation of India, the Indian Oil Corporation, the State Trading Corporation etc, are actually companies and not statutory corporations

(*v*) These undertakings are enjoined to observe business and commercial principles and are also required to earn profits but it is to be noted that the profit motive cannot be such overriding factor in their case as it is in private companies

(*vi*) Because of the shortage of professionally trained managerial personnels in the country, initially and even now, several managerial personnels in these undertakings came from the Government departments and not from the industrial or commercial fields With the result, the approach of the management is not the same as we find in case of private commercial undertakings They followed bureaucratic approach and even now it persists, even though there is some change in the pattern of management Not only this, the terms and conditions of service in these undertakings have to bear a relation to those prevailing in the Government departments

(*vii*) The autonomy of the management of these undertakings is severely restricted due to stricter control and accountability of the management to the Government, and Parliament and several other agencies The managing director of a public undertaking is not as free to act as in case of a private undertaking

(*viii*) For several matters, the management of these undertakings is guided and directed by the concerned ministry The Minister concerned control them formally as well as informally, the latter being more severe often The Government is empowered to lay down policies, issue directions, appoint or replace top officials, approve capital expenditures beyond a prescribed limit, sanction borrowings and investments etc

(*ix*) There are rigid and stricter controls over these undertakings, by host of agencies They are controlled by the concerned

ministry as well as the Parliament. They are made accountable to the public through the Parliament which control them in many ways There is a Parliamentary committee known as Committee on Public Undertakings which examines their working in detail Its report is submitted in the Parliament and action has to be taken on it within the stipulated period The action taken report is also submitted in the Parliament

(*x*) In every undertaking, a Financial Adviser has been appointed who wields considerable power over the management regarding the financial matters of the undertaking His role is quite unique He is a critic as well as a functionary He, in fact, exercises substantial control over the financial matters

(*xi*) Every undertaking is required to submit its annual report in detail in the Parliament every year The Bureau of Public Enterprises publishes a report, namely, 'Annual Report on the working of Commercial and Industrial Undertakings of the Central Government' every year

(*xii*) The audit of these undertakings is normally undertaken by the professional accountants but the Comptroller and Auditor-General of India has the power to conduct an efficiency-cum-propriety audit of these undertakings Under Article 151 of the Constitution of India, the Comptroller and Auditor-General of India has to submit his comments to the Parliament every year

A distinction between the audit of private undertakings and that of public sector undertakings has to be kept in mind This is quite necessary as the professional accountants are required to audit the accounts of both types of undertakings The auditor of a private sector undertaking is, in general, required to undertake the verificatory audit and has to give his opinion as to whether the profit and loss account and the balance sheet exhibit true and fair state of affairs of the undertaking He has nothing to do with the impropriety of the actions of the management He is not to bother about the under-utilisation of the capacity He is not required to question the points of inefficiency of the management He does not bother much about the wastefulness or otherwise of the expenses, the mis-utilisation or the under-utilisation of the assets etc If the targets are not fulfilled, he need not worry and need not qualify his reports on these counts

The auditor of a public sector undertakings has to adopt some of the techniques of Government audit and at the same time follow standard practices and techniques of audit of a private concern The purpose and technique of Government audit is different and that should also be duly followed It has been rightly pointed out that "The government audit is generally an audit against irregularity, sanctions, propriety, and efficiency It seeks to verify whether the expenditure conforms to the various provisions of the law and the rules and whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a

person of ordinary prudence would exercise in respect of expenditure of his own money, whether the expenditure was necessary, and whether the individual items of the expenditure give the best results The Government audit, in effect, is an audit of efficiency also and seeks to find out avoidable delays, wasteful expenditure, misutilisation or under-utilisation of various assets and shortfall in the accomplishment of physical target "

It has been found in practice that the auditors of the public sector undertakings have been adopting bolder approach as compared to those of the private sector undertakings A qualified report by the auditors of private sector undertakings is given only in very exceptional circumstances and is rare But this is not so in case of public sector undertakings In a research study conducted by Prof Laxmi Narain reveals that clean report was submitted only in case of 18 per cent of the undertakings audited in 1965-66 As many as 66 per cent of the reports were qualified subject to notes forming part of the accounts Another 16 per cent had qualifications in the main report also [1] It has been pointed out by him that "the fact that their appointment or reappointment is not dependent on the company which they audit does make them bolder "

There is a greater need for the change in the approach, outlook and attitude of the auditors of these undertakings The auditors should make efforts in such a way as to make themselves acceptable and there is need for a change in the approach of the management also

The latter should not simply think that audit is a necessary evil which has to be tolerated, but as an essential apparatus performing useful function As the public sector undertakings are assuming more and more crucial place in the economy of the country, there is a greater need for better appraisal of their working The auditors must try to see that the operations of these undertakings are conducted with 'wisdom, faithfulness and economy'

We have three popular forms of organisation of our public sector undertakings, as mentioned earlier. They are departmental undertakings, statutory corporations, and the Government companies Let us analyse the provisions and procedures of audit of these different types of undertakings separately

AUDIT OF DEPARTMENTAL COMMERCIAL UNDERTAKINGS

Several Central Government commercial undertakings have been set up in the country as departmental commercial undertakings They are administered as a part of the department, like any Government

1 Laxmi Narain Efficiency Audit of Public Enterprises in India, Orient Longman (1972), pp 152-3

department,[1] The departmental commercial undertakings have been defined as those which are "maintained mainly for the purpose of rendering service or providing supplies of certain special kinds on payment for the service rendered or the articles supplied They perform functions which are not necessarily government functions They are required to work to a financial result determined through accounts maintained on commercial principles " Thus, these undertakings normally either produce something or render some services The examples of these undertakings are Indian Security Press, Nasik Road, Films Division, Bombay, Chittaranjan Locomotive Works, Indian Railways, Post and Telegraph, Atomic Power Projects and opium and alkaloid factories etc.

The statutory basis for the audit of these departmental undertakings is found in the Article 149 of the Indian Constitution This Article provides that "The Comptroller and Auditor-General shall perform such duties and exercises such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by Parliament and until provision in that behalf is so made, shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States as were conferred on or exercisable by the Auditor-General of India immediately before the commencement of this Constitution in relation to the accounts of the Dominion of India and of the Provinces respectively " Thus, Article 149 empowers the Auditor-General to undertake the audit of such undertakings

Even though the audit of such undertakings is carried on the basis of commercial principles or commercial practice or law applicable to private enterprises, yet the Auditor-General has the power to extend his audits in such undertakings to conduct an examination of the authority of expenditure as also of the regularity and propriety of financial transactions It has been pointed out that "The function of audit here is also to ensure that the subsidiary accounts are so prepared as to render it possible to compare the relative efficiency of Government trading and manufacturing institutions with one another or with similar non-government institutions The audit here also aims at verifying the correctness of the allocation of expenditure between capital and revenue, the valuation of assets upon a reasonable basis,

1 The main features of departmental undertakings are as follows (i) the enterprise is financed by annual appropriations from the Treasury and all, or a major share of its revenues, are paid into the Treasury, (ii) the enterprise is subject to the budget, accounting and audit controls applicable to other government activities, (iii) the permanent staff of the enterprise are civil servants, and the methods by which they are recruited and the conditions of service under which they are employed are ordinarily the same as for other civil servants, (iv) the enterprise is generally organised as a major sub-division of one of the central departments of government and is subject to the direct control of the head of the department, and (v) wherever this applies in the legal system of the country concerned, the enterprise possesses the sovereign immunity of the State and cannot be sued without the consent of the government cf U N, *Some Problems in the Organisation and Administration of Public Enterprises in the Industrial Field*, New York, 1954, p 6

and the adequacy of provision for depreciation and bad debts The audit of such undertaking is more than the verificatory audit and efforts are made to analyse the working of these undertakings in detail so that the weaknesses, if any, may be brought to light and remedial actions may be taken in future soon

AUDIT OF STATUTORY CORPORATIONS

A few statutory corporations have also been set up in the country to undertake the commercial and industrial activities For the establishment of these corporations, special Acts have to be enacted through Parliament There are several corporations in financial areas, such as, Reserve Bank of India, Industrial Development Bank of India, State Bank of India, Life Insurance Corporation of India, Unit Trust of India, Agricultural Finance Corporation, the nationalised banks etc Some of these corporations are working in non financial areas, or, in other words, in industrial and commercial areas such as, Damodar Valley Corporation, Food Corporation of India, Central Warehousing Corporation, Air India and Indian Airlines Corporations etc [1]

The enabling statutes of these corporations have made provision for the audit of these corporations In some case, the Auditor-General is fully empowered to undertake their audit and in some cases, the audit is undertaken by the professional accountants The Auditor-General is fully empowered to undertake the audit of Air India, Indian Airlines Corporations, and the Oil and Natural Gas Commission Air India, however, also gets its accounts audited by two firms of the chartered accountants The professional chartered accountants are solely responsible for the audit of accounts of fourteen nationalised banks, Industrial Development Bank, the Industrial Finance Corporation, the State Warehousing Corporation, Life Insurance Corporation, the Food Corporation of India etc Audit by the Auditor-General is provided for in statutory bodies like the Employees' State Insurance Corporation, National Co operative

1 The chief characteristics of statutory corporations are as follows (i) it is wholly owned by the State, (ii) it is generally created by, or pursuant to, a special law defining its powers, duties and immunities and prescribing the form of management and its relationship to established departments and ministries, (iii) as a body corporate, it is a separate entity for legal purposes and can sue and be sued, enter into contracts, and acquire property in its own name Corporations conducting business in their own name have been generally given greater freedom in making contracts acquiring and disposing of property than ordinary government departments (iv) except for appropriations to provide capital or to cover losses, a public corporation is usually independentally financed It obtains funds from borrowing either from the Treasury or the public, and from revenues derived from the sale of goods and services It is authorised to use and reuse its revenues ' (v) it is generally exempted from most regulatory and prohibitory statutes applicable to expenditure of public funds, (vi) it is ordinarily not subject to the budget, accounting and audit laws, and procedures applicable to non-corporate agencies, and (vii) in the majority of cases, employees of public corporations are not civil servants, and are recruited and remunerated under terms and conditions which the corporation itself determines cf U N, *op cit*, p 9

Development Corporation, Khadi and Village Industries Commission, Port Trusts and Commodity Boards etc

In case of Reserve Bank of India, at least two auditors are appointed by the Government and they continue for one year They can, however, be reappointed In case of L I C, the auditor is appointed by the Corporation itself with the previous approval of the Central Government The audit report is forwarded to the Corporation who forwards it to the Central Government A bunch of 12 auditors have been auditing the Corporation In case of Food Corporation of India, the chartered accountants are appointed to audit its accounts The appointment is made out of the list of auditors approved by the Central Government on the advice of the Auditor-General. It is notable that it is only in case of this Corporation that the Auditor General approves the list of Chartered Accountants The audit report is sent to the Central Government In case of D V C, the audit is undertaken by an officer of the Auditor-General and it is countersigned by the Auditor-General In case of State Bank of India, two chartered accountants are appointed by the Reserve Bank of India in consultation with the Government, who will also fix their remuneration The appointment is made for one year but he can be reappointed The Government is also entitled to appoint such additional auditors any time it thinks fit to examine and report on the accounts of the Bank The audit report has to be submitted to the Government and also the State Bank

The form and the content of the audit report, as prescribed for various corporations, are similar to those prescribed under the Companies Act, 1956 They do not differ also materially The form of certificate is prescribed in case of two air corporations and Oil and Natural Gas Commission It may be pointed out that Auditor-General is the sole auditor for them The certificate to be given should be as follows "I have obtained all the information and explanations that I have required and certify, as a result of my audit, that in my opinion these Accounts and Balance Sheet are properly drawn up so as to exhibit a true and fair view of the state of affairs of the concern according to the best of any information and explanations given to me and as shown by books of the concern "

In case of Reserve Bank of India and Industrial Finance Corporation, the certificate, as prescribed, refers only to the balance sheet The auditor has to report that the balance sheet is 'full and fair' and that it exhibits a 'true and correct view' of the state of affairs of the enterprise For other undertakings, which are audited by the professional auditors, the form of certificate is more or less the same as prescribed under the Companies Act, 1956

AUDIT OF GOVERNMENT COMPANIES

A majority of the public sector undertakings, as mentioned earlier, has been set up as Government companies and that too as private limited companies, under the Companies Act, 1956. The

audit of such undertakings is also governed by the Companies Act, 1956 Section 619 contains the provisions regarding the audit of such Government companies It provides for audit by professional firms of chartered accountants appointed on the advice of the Auditor-General by the Government The Auditor-General is also empowered to issue instructions to these auditors in the conduct of their work He is also authorised to carry out a test or supplementary audit

Section 619 of the said Act contains the provisions of the audit of Government companies and it has also been provided that this Section will supervene the provisions of Sections 224 to 233, if there is anything inconsistent with these Sections It may be pointed out that Sections 224 to 233, provide for the appointment, remuneration, qualifications, disqualifications, powers, duties, rights and liabilities of the auditors, and the form of the audit report, etc

According to Section 619(2), the "auditor of a Government company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor-General of India"[1] In practice, the Government company sends the names of the firms of practising chartered accountants to the Central Govern-

1 Section 619 of the Companies Act, runs as follows (1) In the case of a Government company, the following provisions shall apply, notwithstanding anything contained in sections 224 to 233 (2) The auditor of a Government company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India (3) Comptroller and Auditor-General shall have power—(a) to direct the manner in which the company's accounts shall be audited by the auditor appointed in pursuance of sub-section (2) and to give such auditor instructions in regard to any matter relating to the performance of his functions as such, (b) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf, and for the purposes of such audit, to require information or additional information to be furnished to any person or persons so authorise, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may, by general or special order, direct, (4) The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit, (5) Any such comments upon, or supplement to, the audit report shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report

The Companies (Amendment) Act, 1974 introduced a new Section 619B which runs as follows The provisions of section 619 shall apply to a company in which not less than fifty-one per cent of the paid-up, share capital is held by one or more the following or any combination thereof, as if it were a Government company namely, (a) the Central Government and one or more Government companies, (b) any State Government or Governments and one or more Government companies, (c) the Central Government, one or more State Governments and one or more Government companies, (d) the Central Government and one or more corporations owned or controlled by the Central Government, (e) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government, (f) one or more corporations owned or controlled by the Central Government or the State Government or, (g) more than one Government company

ment who forwards the request from the companies to the Auditor-General Finally, the Auditor-General appoints or reappoints the auditors Thus, for all practical purposes, the auditors are the 'nominees' of the Auditor-General, though legally it is the Government who is the appointing authority Sometimes, the Auditor-General does not choose the name of auditor out of the names submitted to him by the Government It may be pointed out that the limits prescribed under Section 224 (I-B) and (I-C) also apply to the Government companies

In practice, the Auditor-General maintains a list of the firms of Chartered Accountants out of which he makes the appointment For the purpose, he obtains certain specified information from the firms of chartered accountants so that he may be able to assess their capacity and competence to undertake the audit of the Government companies Such information may relate to the "qualifications of the partners and the places where they are practising, the names of the employed chartered accountants, if any, working in the firm together with the dates from which they are in employment , in case any partner or a paid chartered accountant of the firm is practising independently or is working also in another firm as partner or employees, the details thereof, the number of other staff for audit work, addresses of the branches, if any, and the names of the chartered accountants supervising the branches, date of registration of the firm as partnership, particulars of audit work with the firm giving the total number of limited companies and the total turnover, names and turnover regarding audit of banks, insurance companies and other financial institutions indicating the information pertaining to branches separately, the total number of other institutions and the total turnover from audit, and particulars of other assignments with Government companies regarding statutory audit, internal audit, management services, etc , held currently or in the previous three years." These particulars help the Comptroller and Auditor-General in making selection of the auditor for the purpose of auditing the accounts of such undertakings

The *remuneration* of the auditors of such undertakings is fixed by the Government as it is the appointing authority also. There is no mention of the auditor's fees or remuneration in Section 619 of the Companies Act The Auditor General also does not have any say in the matter although, in practice he appoints the auditor It has been suggested that the auditor's fees should be fixed by the Auditor-General as he is the "right authority to fix the fees because he could appreciate better the quantum of work involved in a particular audit "

Instructions to auditors

The Auditor-General is empowered, under Section 619, "to direct the manner in which the Company's accounts shall be audited " He is also empowered to give to such auditors "instructions in regard to any matter relating to the performance of his functions as such "

The report prepared by the auditors in accordance with the instructions so issued is normally sent to the Auditor General and not the shareholders It is not submitted alongwith the report under Section 227 of the Companies Act It has been pointed out that it is not a good practice as "the public is not aware of the work done by the company auditors on the basis of special instructions and directions issued to them, except for a very abridged version of these that is presented to the Audit Reports (Commercial)" In fact, these instructions enlarge the duties of the auditors substantially and they are required to probe the matter deeper and need not be satisfied with the verificatory audit alone

Supplementary Audit

Section 619 (3) (b) of the Companies Act empowers the Comptroller and Auditor-General 'to conduct a test or supplementary audit of the company's accounts by such person or persons as he may authorize" Such test or supplementary audit is undertaken either by himself or by any other person on his behalf in addition to the audit undertaken by the professional auditor This power has been given to him as a measure of safeguard and such supplementary audit is normally undertaken when it is found through regular audit that there is a gross irregularity or mismanagement in the company. In practice, such audit is undertaken each year only in case of a few companies only For other companies, some comments, termed as audit paras, are given All these are presented to the Parliament every year as a part of the Audit Report (Commercial)

Audit Report

Section 619 (4) of the Companies Act requires that the professional auditors of the Government companies should submit a copy of their report to the Auditor-General The latter "shall have the right to comment upon or supplement the audit report in such a manner as he may think fit" Section 619 (5) of the Act requires that the 'comments upon or supplement' to the audit report shall be placed before the Annual General Meeting of the company at the same time and in the same manner as the audit report from the chartered accountants

No form of audit report has been prescribed for the Government companies under Section 619 The form of audit report shall be the same as is prescribed for other companies under Section 227 of the Companies Act, given in an earlier chapter

Directions by Comptroller and Auditor-General

Section 619 (3) (a) empowers the Comptroller and Auditor-General "to direct the manner in which the Company's accounts shall be audited" The Auditor-General, however, did not exercise his right of issuing directions for about six years after such right was conferred to him under Companies Act, 1956 The First Directive was issued in 1961 and it covered three financial years, namely,

1961-62, 1962-63 and 1963-64 The Second Direction was given in an elaborate way in May 1965

The Comptroller and Auditor-General issues such direction in the questionnaire form which has to be answered by the professional auditor in addition to his report under Section 227 (2)

The latest directions issued by him are divided into eight parts and include specific questions on systems of accounts and book-keeping internal control, manufacturing and production accounts, cost accounts, profit and loss account, balance sheet, township, manpower, service units, and analysis of accounts to show capital formation, growth and fund flows of the company This definitely extends the scope and duties of auditors of Government companies and they are required to undertake the propriety-cum efficiency audit of such companies They are not simply required to undertake verificatory audit and state that the profit and loss account and the balance sheet show true and fair state of affairs of the company They are required to point specific cases of deficiencies, if any, the areas of wastages, misutilisation of resources and funds, underutilisation of capacity, significant ratios and funds flow statement etc They are required to point out important deficiencies in the financial and cost accounting systems They have to find out and state the variation between the standards fixed and actual results They have to mention about the valuation of stock, the pricing of the inventory and variations made in the system of valuation, if any They have to point out if the machinery was utilised fully or not or if the machinery remained idle, period for which it remained idle etc and host of such other matters, as pointed out below in the specimen of directions All these definitely increase the duties and responsibilities of the auditors of the Government companies

SPECIMEN OF DIRECTIONS ISSUED BY COMPTROLLER AND AUDITOR-GENERAL UNDER SECTION 619 (3)

I SYSTEM OF ACCOUNTS AND BOOK-KEEPING

In respect of the following matters, please offer your observations on the basis of your examination of the books of account of the Company

(1) Are there any important deficiencies in the accounting system for the purpose of "auditing in depth" and in the manuals and other instructions laying down the detailed accounting procedure and specifying the financial powers, duties and responsibilities of the different officers ?

(2) Is there an effective system of reconciliation of the books by taking out periodical trial balances and is the reconciliation of the bank accounts, control accounts and subsidiary accounts (including those pertaining to the branches and units) up-to-date ?

(3) Are property/plant Registers kept up to-date and reconci-

led with the financial books? Important cases of failure to report to the Accounts Department regarding the disposal of items of property, plant and equipment may be mentioned

(4) Is the allocation of expenditure during construction between capital and revenue properly done so that the cost of an identifiable unit of plant (e g coke oven in steel plant) can be ascertained? If not, the defective cases should be indicated

II. INTERNAL CONTROL

(1) Has a manual outlining the scope and programme of work for the internal audit been drawn up? If so, had the programme been kept up?

(2) (*a*) Are you satisfied that the important points thrown up by the internal audit have been considered by the Administration and necessary action taken? If not, indicate the more important points on which consideration/action is outstanding Have any drawbacks in the system of internal control been noticed?

(*b*) Is the procedure for write-off, discounts, refunds, etc, adequate? Have any receipts been foregone in the shape of unusual concessions involving material amounts allowed to customers, in the form of discount, rebate, wastage etc? If so, instances may be given indicating the amount involved

(*c*) Is there an adequate procedure in force for recovery of charge for materials issued in respect of major consideration works? Have you noticed cases where charges for materials etc, issued have not been recovered? If so, instances may be given indicating the amount involved

(*d*) (*i*) In what classes of cases does the company's purchasing procedure provide for the calling of open tenders? Is the prescribed procedure for the calling of open tenders considered adequate? Give instances exceeding Rs individually, if any, which have come to your notice, in the course of your audit (a) where such procedure has not been followed, and (b) where lowest tender has not been accepted though open tenders were called for Reasons given by the management in both type of cases should be indicated

(*ii*) What is the purchase procedure followed in regard to other items where open tenders are not invited, e g, whether questions are obtained from a panel of suppliers maintained?

(3) Does the company prepare capital, revenue, production

and sales budgets for a financial year with adequate details sufficiently in advance ? If so, the actual performance, in relation to the original budget provision and the reasons given by the management for abnormal variations, if any, may be indicated

III. MANUFACTURING AND PRODUCTION ACCOUNTS

(1) (*a*) In the case of manufacturing companies, has the consumption of major raw materials for manufacture of major product been more than the estimated quantity as per projects report or norms fixed by the management ? If so, indicate such cases (Minor variation may be ignored)

(*b*) In the case of construction companies, has the consumption of major materials for construction of major projects been more than the estimated quantity as per projects report or norms fixed by the management If so, indicate such cases (Minor variations may be ignored)

(2) Does the company maintain periodical quantity accounts of production of the major products ? What were the rated capacity, target fixed by the management, and the actual production of the major products during the last 3 years ?

(3) Are the existing manufacturing accounts drawn up properly ? Where appropriate, the lines of improvement may be suggested

(4) Are records maintained for determining the rejections in production ? Have you noticed any abnormal variation ?

(5) *Cost Accounts*

(*a*) Does the company prepare accounts indicating the cost of each unit of its major products ? Have you any comments to make on the effectiveness of the system of costing and also any suggestions to make on the maintenance of cost records or distribution of overheads ? Are the costs compiled in time or is there a time lag in the compilation of costs ?

(*b*) Have standard costs of various main products been fixed ? How did they compare with the actual cost of production during the last 3 years ?

(*c*) In the case of companies undertaking construction or repair contracts, how do the cost estimates prepared by the company for the purpose of quotations for undertaking such work compare with the actual costs? Give instances, if any, which have come to your

notice where the estimated cost was considerably lower than the actual cost

(*d*) Has the company a system of ascertaining the idle time for labour and machinery, specifying the reasons therefor ? Cite instances, if any, which have come to your notice, of machinery costing more than Rs. 5 lakhs which had remained idle for more than three months

IV. PROFIT AND LOSS ACCOUNT

(1) Is the method of valuation of closing stock and work-in-progress acceptable ? Defect, if any, may be indicated with any suggestions for improvement

(2) Indicate the method of depreciation adopted and your comments, if any

(3) How do the selling prices compare with cost of production? Indicate separately whether material losses were incurred on the sale/trade of major commodities dealt with. Give the management's reasons for the loss

(4) Were there any special features in the year which have affected the results shown by the profit and loss account substantially ?

(5) What is the break-up of turnover, i e, value of sales/business in respect of major products for the past 3 years. The percentage of increase or decrease for the total turnover of major products, with the management's reasons for the variations, may be given

(6) Indicate instances where substantial demurrage has been paid

V. BALANCE SHEET

(1) *Sundry Debtors*

(*a*) Mention important cases of failure to obtain confirmation of outstanding debts

(*b*) Mention the details of debts outstanding for more than one year in the following form .

(*i*) Debts over 1 year but less than 2 years

(*ii*) Debts outstanding for 2 year but less than 3 years.

(*iii*) Debts outstanding for 3 years and above.

(*c*) Is the system of allowing credit reasonable ?
Are the debts vigorously pursued ?

(2) *Plant and Machinery*

Have all items of plant and machinery costing more than Rs .... lakhs each been installed and commissioned? In case of non-commissioning of such plant, which are the reasons given by the management?

(3) *Inventory Procedure and Control*

(*a*) Is the pricing of stores issued done on a uniform basis?

(*b*) What are the results of the physical verification of stocks of finished and semi-finished goods, stores and spares, and raw materials conducted periodically by the company? What action has been taken by the management on the excess and shortages revealed as a result of such physical verification? Are you satisfied with the system of physical verification?

(*c*) Does the system of procurement and disposal of stores ensures that (*i*) stores in excess of the reasonable requirements of maintenance and production are not accumulated, (*ii*) the amount of (*a*) surplus (*b*) unserviceable stores are periodically determined, (*iii*) surplus and unserviceable stores are disposed of without undue delay?

What is the value of stores declared as surplus or obsolete in the last three years? Indicate how much has been awaiting disposal for more than (*a*) one year (*b*) two years

(*d*) Indicate the class of items where maximum and minimum limits of stores/spares holding have not been fixed Indicate also the classification and value of stores/spares which have not moved for 3 years and more

(*e*) How many months' cost of production did the total stock inventory work out to for the past 3 years? A table may be given in the following form

	Year	*Year*	*Year*
(*i*) Cost of Production			
(*ii*) Inventory as at the end of the year			
(*iii*) Inventory in terms of number of months' cost of production			

(*f*) How many month's consumption was represented by the stock of raw materials, stores and spares held as at the date of the balance sheet during the past 3 years?

(*g*) How many months' cost of production was the work-

in-progress equivalent to during the past 3 years ? The figures of total cost of production and work-in-progress for these years may also be given

(h) Has there been substantial accumulation of finished products ? Give instances which have come to your notice where the value of the closing stocks of such products exceeds the value of six months' sales of these products.

(4) *Working Capital*

How many months' cost of production/business was represented by the total working capital ?

VI GENERAL REVIEW

(1) Are proforma accounts maintained in respect of the operation of service units, for the benefit of staff during the last 3 years, e g., transport, canteen, etc. If so, the results may be indicated

(2) The following ratios for the last three years may be given :

(a) Long-term loans to paid-up capital

(b) Net current assets to fixed assets.

(c) Gross profits to sales

(d) Return on capital invested (share capital, long-term loans and free reserves). The profit will include interest on long-term loans

You may give also any other ratios which you feel might offer significant information in the case of the particular company under review.

(3) How does the man-power actually employed compare with the man-power envisaged in the Project Report/Norms fixed by management ? A statement showing the comparative figures may be given

VII TOWNSHIP

(1) What is the amount of financial assistance, if, any, availed by the company under the subsidised housing scheme for industrial workers ? The amount of financial assistance sanctioned but not availed of, and the reasons therefor given by the management may be indicated

(2) The actual expenditure on township and the percentage of such expenditure to the actual capital outlay may be given.

VIII. GENERAL

A general analysis of the accounts indicating capital formation, growth of the company, sources and used of funds may be given in the performa appended (Tables 1 and 2).

TABLE 1

GROWTH AND WORKING OF IN THE LAST FOUR YEARS

	Particulars	year	year	year	year
1	Rates of growth [percentage increase (+) or decrease (—) per annum]				
	A. *Liabilities and Assets*				
	1 Paid-up capital plus reserves and surplus (net worth)				
	2. (*a*) Gross fixed assets				
	(*b*) Net fixed assets				
	3 Inventories				
	4 (*a*) Gross fixed assets plus inventories				
	(*b*) Net fixed assets plus inventories				
	5 (*a*) Total gross assets				
	(*b*) Total net assets				
B.	*Income and Profits*				
	1 Total income				
	2. Sales				
	3 Cost of production				
	4 Profits before tax				
	5 Profits after tax				
	6. Retained Profits				
	7 Dividends				
II	*Profit Ratios*				
	1 Retained profits as percentage of profits before tax				
	2 Gross profits as percentage of total capital employed				
	3 Gross profits as percentage of sales				
	4 Profits after tax as percentage of net worth				
	5 Dividends as percentage of paid up capital				
	6 Dividends as percentage of net-worth				
III.	*Other Ratios*				
	1 External sources as percentage of total sources of funds				
	2 Increase in borrowing from Govt as percentage of external sources				

TABLE 2

STATEMENT SHOWING SOURCE AND APPLICATION OF FUNDS

SOURCES OF FUNDS

Internal Sources

Net Profit (Loss) for the year after taxation, depreciation provided in the accounts

Increase in reserves by debit "above the line"

Increase in non-current provisions, such as provision for gratuity, etc

Sales of Fixed Assets

External Sources

Paid-up capital

Borrowings from Govt /Banks

Borrowings from statutory Financial Corporations

Issue of Debentures

Other Borrowings

Decrease in net current assets

APPLICATION OF FUNDS

Additions to Fixed Assets

- Land
- Buildings
- Plant and Machinery
- Others

Purchase of Investments

Increase in net current assets

Intangible assets

Miscellaneous expenditures

QUESTIONS

1. Describe main features of a public sector undertaking which affect its audit

2 Describe the procedure for audit of (*a*) departmental undertakings, and (*b*) statutory corporations

3 Explain briefly the provisions of Companies Act, 1956 regarding audit of a Government company.

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Audit of Sole Traders and Partnerships

SOLE TRADERS

A sole trader is under no legal obligation to get his accounts audited by a duly qualified auditor But the advantages which one derives by having the accounts audited have tempted most of the sole traders to appoint auditors regularly It is necessary specially to those who carry on business on a relatively large scale and whose incomes and expenditures are heavy It is not necessary, however, for petty shopkeepers, hawkers and vendors to get their accounts audited They cannot bear the expenses on audit as they have limited financial resources

Audit is necessary to relatively large concerns, run by individuals, due to following chief reasons

(*i*) It would ensure the proper maintenance of books of account.

(*ii*) It assures the sole traders that their accounts are correct, all the incomes and expenditures are properly entered in the books of account, the results of trading indicated by the accounts are correct, and financial picture of the business as presented by the accounts is true and fair

(*iii*) The audited accounts present uniformity from year to year, and it renders the comparison of accounts of different years possible It is quite necessary to trace the fluctuations in the earnings of the concern from year to year, only then the causes may be unearthed and policies may be framed in such a manner as would improve the whole financial situation of the business

(*iv*) In case the individual entrepreneur is assisted by many employees over whom he does not have effective control, the audit of accounts becomes necessary with a view to detect frauds, errors and maladjustments

(*v*) Audited books of account will be more reliable and useful for—

(*a*) income tax and sales-tax assessment,

(*b*) securing compensation from the insurance companies in the event of loss by fire etc.,

(*c*) borrowing moneys from banks,

(*d*) calculation of purchase price, goodwill etc in the event of sales of the concern

(*e*) presentation, as an evidence, in the courts, when necessary

Special Considerations before the commencement of Audit An auditor is appointed under a contract with the trader It is not done under any statute But before he actually commences examination of books, he should pay attention to the following points at the time of his appointment

(*i*) The contract for his appointment should be in writing. This point was emphasised in *Apfel v Annan Dexter & Co* (1926) He should have instructions in clear words

(*ii*) The scope of audit and his duties should be clearly mentioned. He should enquire whether the trader requires partial or complete audit of his books or account The extent to which he has to perform his duties should write to his client regarding this and get a confirmatory reply which will serve as evidence in future In case any limitation has been imposed upon his work, that should also be obtained in writing in ambiguous words.

(*iii*) Whether he has to act as an accountant for the preparation of accounts, or only to conduct the audit of the accounts, or both, should be clearly enquired into to avoid any confusion and dispute in future In *Apfel v Annan Dexter & Co*, (1926), it was emphasised that the auditor should arrive at a clear understanding with his client in all cases where full audit is not to be carried out In this case the auditor acted as an accountant only Similar points arose in *Maritime Insurance Co, Ltd v William Fortune & Sons* (1931) and *Leech v Stokes and Others* (1937)

(*iv*) He should have correspondence with the auditor appointed previously, if any, and find out why this change has been affected.

Procedure There is nothing special with regard to the application of principles and procedures for the audit of the accounts of the sole traders carrying on usual types business Same principles and techniques of auditing which have been mentioned in detail in previous chapters have to be applied in this case However, the auditor has to apply his own discretion and judgment based on past experience and knowledge In different businesses different situations prevail which must be kept in mind. It most of the cases, the auditor will find absence of any system of internal control It would necessitate detailed checking rather than test checking Such detailed checking in quite practicable where the transactions are not numerous The auditor must satisfy himself that all the transactions have been accounted duly and there is no omission He must satisfy himself about the fairness of the accounts and submit his opinion accordingly through his report to the client.

During the course of audit an auditor may often find that many personal expenses of the owner have been paid with business funds and charged in the accounts as business expenses On the other hand, he may find that certain business expenses been have paid from the owner's personal funds but there is no such reflection in the books of account in this connection Under such circumstances, the auditor should have informal discussions with his client and find out the areas in which such discrepancy may exist At the same time, he should point out to his client the desirability of making a proper distinction between the business and the personal funds So far as possible the auditor should trace out such expenses and see that the personal expenses have been excluded from the accounts It should be done by means of an adjusting entry transferring from the expenses account to the owner's drawings account.

The requirements of the auditor's report are the same as in the case of a partnership firm and are given at the end of the Chapter

PARTNERSHIP FIRMS

Audit of partnership accounts is also not legally compulsory as in the case of sole traders There is no statutory provision and the Indian Partnership Act of 1932 is also silent on the subject It does not require the accounts of firms to be audited by a duly qualified auditor as required by Indian Companies Act, 1956 for companies The joint proprietorship of a firm by two or more persons may result into friction and dissatisfaction on the part of the partners relating to the accounts These possibilities are greater when the firm is actually run and managed by one partner alone and others remain dormant An independent auditor's opinion with regard to the correctness of accounts is thus desirable even though it is not legally compulsory That is why most of the firms get their accounts audited annually and regularly The Partnership Deeds of various firms usually contain a clause to this effect

Advantages. In addition to the advantages commonly derived from all forms of audit such as detection and prevention of frauds or errors, verification of correctness of accounts etc, the following particular advantages may be derived by a firm by getting its accounts audited

(*i*) The audit by an independent auditor settles the disputes and frictions, if any, between the partners related to the accounts It brings satisfaction to them with regard to the management and maintenance of accounts and results of the trading.

(*ii*) In case there are sleeping or dormant partners who have simply invested capital and do not take active part in the management of the firm, the audit of accounts on their behalf assists them in verifying the correctness of accounts maintained by active partners and the shares of profits due to them

(*iii*) It is quite helpful for income-tax purposes or for borrowing money from banks etc.

(*iv*) In the event of change of constitution of the firm, due to death or retirement of a partner, or admission of a new partner etc, the audited accounts are quite advantageous to settle and adjust the accounts between the partners and calculate the amount of goodwill etc

(*v*) Auditor's periodical visit and helpful suggestions may be quite useful for improvement in the management of the firm.

Distinction between Audit of a Firm and Audit of a Company Although the objectives of the audit of a firm are the same as that of a company, viz verification of Final Accounts and detection and prevention of frauds and errors etc, there are certain essential points of difference between the audit of a firm and that of a company

(*i*) The audit of a partnership is performed under the partnership agreement or by mutual agreement between the partners. The audit of accounts of a company is performed under the statute It has been made compulsory by Indian Companies Act, 1956

(*ii*) In case of the audit of a company, the appointment of auditor is made by shareholders, in general, in accordance with the provisions of the Act His remuneration is also fixed accordingly His rights and duties are defined under the Act This is not so in the case of firm's audit where everything is decided by the agreement between the partners and the auditor

(*iii*) The scope of the audit of a firm may be limited by the partners and in that case, the auditor should try to get clear instructions in writing But this cannot be done in case, of a company audit The rights and duties of a company auditor cannot be limited by the Articles of the company or through resolutions passed in its general meeting These statutory duties, however, can be extended if desired

(*iv*) The auditor of a firm has to see that its accounts have been maintained according to the express provisions of the partnership agreement or the express instructions of the partners. Only in the absence of any such provisions will the provisions of the Indian Partnership Act, 1932 be applicable In the case of a company, the auditor has to see that the accounts have been kept according to the provisions laid down in the Memorandum and Articles of Association and the resolutions passed by the company and the directors Besides, the auditor has to see that all the provisions of the Act related to the accounts of the company have also been duly observed and complied with

(*v*) In case of a firm the auditor has to report to the partners, but in case of a firm the auditors has to report to the members of the company whether he is appointed by them or not

(*vi*) So far as the auditor's liabilities are concerned, an auditor of a firm is liable only for negligence and not for misfeasance or criminal offences as the auditor of a company may be

Special Considerations before the Commencement of Audit In case of the first audit of a firm, the auditor should acquaint himself with the business of the firm and various other points mentioned below before he actually proceeds with the auditing of its accounts

(*i*) He should see that the contract for his appointment with the client is in writing He should have written instructions with regard to the scope of the audit and the work he has to perform He should enquire whether he has to perform partial or complete audit In the absence of such clause in the contract, he should send a letter to his client seeking instructions He should proceed further only after receipt of such confirmatory letter

(*ii*) He should obtain a copy of Partnership Deed and read it carefully, specially those clauses which affect the accounts In the absence of such written agreement, he should ascertain if there is any statement of agreement between the partners The auditor has to note that the provisions of Indian Partnership Act, 1932 relating to the accounts etc, will be applicable if there is no express or implied agreement between the partners

(*iii*) He should then enquire about the system of internal check if any, in operation in the firm He should find out the weak points of the system, if any

(*iv*) He should obtain a list of books of account kept by the firm, and also information with regard to the system of accounting in use.

(*v*) He should get a list of members of the staff together with their names, powers and duties

(*vi*) He should find out the contracts, if any, entered into by the firm with third parties

(*vii*) He should find out the powers and duties of the partners, ratio in which they distribute profits, agreements for interest on capital etc

(*viii*) He should acquaint himself with the technicalities of the business of the firm as may affect his job later on

The **Partnership Deed** is a very important document in case of a firm. It contains mutual agreements, rules and regulations for carrying on the business The auditor should study it carefully and in detail He should note all its provisions affecting the accounts, specially in case of the first audit of the firm The main clauses of the Deed which should draw his special attention are as follows .

(*i*) Duration of the partnership

(*ii*) Period for which the accounts are to be prepared

(*iii*) Amount of capital contributed by each partner

(*iv*) Proportion in which the partners are to share profits or losses

(*v*) Provisions with regard to charging of interest on the Drawings and Current Accounts and allowing of interets on capital

(*vi*) Provisions related to the partners' drawings

(*vii*) Whether any partner is allowed to draw salary before the calculation of the net profit of the firm

(*viii*) Provisions related to the borrowings of money by the firm In case the loan is taken from a partner, the rate of interest to be allowed on it

(*ix*) Provisions for depreciation and reserves.

(*x*) Provisions with regard to the determination of share of outgoing partner and the valuation of goodwill etc, on the retirement or death of a partner

(*xi*) Whether the authority of any partner is limited and if so, to what extent.

(*xii*) The circumstances under which the partnership may be dissolved or any other arrangement to be applied in the event of dissolution

(*xiii*) Any other point affecting the accounts

The Indian Partnership Act, 1932 and the auditor In the absence of any express or implied agreement between the partners, the provisions of the Indian Partnership Act, 1932 are applicable The auditor should see that, under such circumstances, the provisions of the Act related to the accounts of firm or those which may concern the auditor are as follows

(*i*) Every partner has to share equally in profits or losses of the firm [Section 13 (b)]

(*ii*) A partner is not entitled to receive remuneration for taking part in the conduct of business of the firm [Section 13 (a)]

(*iii*) A partner, in general, is not entitled to draw interest on the capital contributed by him, but if he is so entitled, he can draw if only out of the profits of the firm [Section 13 (c)]

(*iv*) If a partner has advanced loans to the firm, over and above the contribution of capital invested by him, he is entiled to draw interest at 6 per cent per annum only on such loans and advances

(*v*) Evey partner has a right to have access to and inspect and copy any of the books of the firm [Section 12 (d)]

(*vi*) Every partner has right to take part in the management of the business of the firm [Section 13 (d)]

(*vii*) The property of the firm shall be held and used by the partners exclusively for the purpose of the business alone (Section 15)

(*viii*) Every partner has an implied authority to bind the firm by his act in the ordinary course of business of the firm (Section 19)

(*ix*) In case a partner has incurred any liability in the ordinary course of business or in the preservation of the firm's property, he must be indemnified for the same [Section 13 (e)]

(*x*) A partner will have to account for and pay to the firm any profit which he earned for himself from any transaction of the firm or in the firm's name or from the use of the property or business connections of the firm Similarly, if any partner has established competing business without the consent of other partners and earns a profit, he must account for and pay this also to the firm (Section 16)

(*xi*) At the same time, the firm is also liable—

(*a*) if a partner, acting within the scope of his apparent authority, receives money and misapplies it, or

(*b*) if the firm, in the ordinary course of the business receives money which is misapplied by a partner (Section 27)

(*xii*) On the death or retirement of a partner, if there is no final settlement and the surviving and continuing partners are carrying on the business, the outgoing partner or his estate has the option of claiming—

(*a*) such share of profits as may be attributable to his share or the assets , or

(*b*) interest at 6 per cent per annum on his share of partnership assets (Section 37)

(*xiii*) In the event of dissolution of the partnership every partner has a right to dispose off its goodwill for the common benefit (Section 55)

(*xiv*) In case the firm is dissolved—

(1) losses including deficiencies of capital, if any, must be made good first out of net profits, then out of capital and lastly by the partners individually in the proportion in which they share profits ,

(2) the assets of the firm have to be applied in the order as follows

(*a*) in payment of the firm's liabilities to third parties ,

(*b*) in payment of the partners' advances and loans ,

(*c*) in repayment of partners' capital ,

(*d*) the balance, if any, has to be divided between the partners in the proportion in which they share profits (Section 48)

(*xv*) In the absence of any usage or custom of trade to the contrary, under Section 19 (2), the partners do not have the implied authority to—

(*a*) submit a dispute of the firm to arbitration,

(*b*) open a banking account their own name,

(*c*) compromise or relinquish any claim or portion of a claim by the firm,

(*d*) withdraw a suit or proceedings filed on behalf of the firm,

(*e*) admit any liability in a suit or proceedings against the firm,

(*f*) acquire immovable property on behalf of the firm,

(*g*) transfer immovable property on behalf of the firm,

(*h*) enter into partnership on behalf of the firm

AUDIT REPORTS OF SOLE TRADERS AND PARTNERSHIPS

On completion of the audit of the accounts of sole traders and partnerships, the auditor must submit a report to the client giving his opinion as to the correctness of the Final Accounts Unlike the companies, there are no statutory provisions with regard to the content of the auditor's report on the accounts of sole traders and partnerships As such he is at liberty to write it in any form he may prefer In practice, the auditors have often given quite short reports, like "Examined and found correct" or "Audited and found correct" They also write a long report in the form of a letter mentioning the points in great detail However, an auditor should not try to give a very short report in the words given above If he has audited the accounts exhaustively seeking informations and explanations, wherever necessary, and finds that the records indicate the correct view of the state of financial affairs, he must mention all these facts in clear words in his report. He must be very precise and clear

Any limitation imposed on him for the purposes of audit or any discrepancy which he discovers while auditing must be disclosed in the report If he was called to take up partial audit, he must qualify his report with this fact, limiting his responsibility undertaken At the same time, he must mention the capacity in which he was called upon to act If he was called to perform some specific duties with specific purposes, he should report the fact If he simply prepared the accounts and did not audit them, it must be disclosed very clearly to avoid any dispute in the future. He should keep in mind

that his report would be relied upon by the third parties also in their dealings with sole trader or firm He may be held liable if they suffer damages because they relied upon a report which was not correct or was misleading

The Central Board of Revenue has, however, prescribed a form of the audit report in the cases of non-companies To bring about uniformity this form may be adopted by the auditor to give his report on the accounts of the sole traders and partnership firms The Form is as follows

Form of Report

"We have audited the foregoing Balance Sheet as at . and the Profit and Loss Accounts for this year ended with the books and vouchers as mentioned by the said and report that—

(*i*) we have obtained all the informations and explanations we required,

(*ii*) the said Profit and Loss Account and Balance Sheet are drawn up in accordance with the said books and

(*iii*) in our opinion, the Balance Sheet contains a correct summary disclosing the general nature of property and assets and capital and liabilities and the basis of valuation of fixed assets and stocks and it exhibits a true and correct view of the state of the affairs, according to the best of our information and explanation given to us and as shown by the books of the said "

Place Signature

Date Chartered Accountant(s)

Whether the above form is adopted or not, the auditor must give the report certifying the Final Accounts as correct But his report should be clear, concise and unambiguous He must take care to qualify the report, if he feels necessary without any hesitation He may qualify it for reason of carrying on partial audit, availability of incomplete records, unsatisfactory, explanations given to him, or insufficient or incomplete vouchers produced, or his services had been requisitioned for specific purpose only, etc He must report the facts honestly While writing his report he must keep his duties foremost in his mind He must not be led away by sentiment and must bring all the facts to the knowledge of his client

QUESTIONS

1 Describe the importance of audit of sole traders and partnership firms

2 Describe briefly (*a*) the special considerations before the commencement of audit, and (*b*) audit procedure of a sole proprietary concern

3 Explain the advantages of audit of accounts of a partnership firm and point out distinction between audit of a firm and audit of a company

4. Describe special points to be kept in mind by an auditor before commencement of audit of a partnership firm

5 You have just finished the audit of a partnership firm. Draft your report for the same

6 Mention the provisions of Indian Partnership Act, 1932 which affect the accounts and draft a report, as an auditor for the firm.

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Special Points in Different Classes of Audit

RAILWAY COMPANIES

1 He should thoroughly examine the provisions of the Special Act of Parliament under which the railway company has been established He should make a special study of the provisions affecting the accounts He should also acquaint himself with the system of internal check and the internal audit existing in the company

2 Verify the entries made in the Traffic Summary Book which relates to the various traffic receipts, with the help of the Returns of the Station Masters

3 Check the remittances of cash by the Stations in the Returns of Cash and the Subsidiary Cash Book He should also check their entry in the Cash Book proper

4 Verify the entries made in the Clearing House Journal with the help of the Railway Clearing House Statements

5 Ledger Accounts should be verified specially for the receipts in respect of passengers, goods, minerals etc

6 Examine the original vouchers to check the various items of expenditures

7 Ascertain whether proper distinction has been made in the allocation of expenditures between revenue and capital For the capital expenditures made the certificate from the proper authority should be ascertained and examined.

8 Verify all the investments with the help of the securities and the Title Deeds etc.

9 Outstanding liabilities should be checked with reference to the certified Returns from the Stations

10 Unearned amounts by way of the unexpired portion of season tickets should also be verified, and it should be seen that it is carried forward

11 Ascertain that the stock and the stores on hand are duly certified by the responsible officials

12 Examine the provisions made with regard to depreciation and other contingencies

13 Check the balances from the General Ledger to the Final Accounts

14 Examine the Final Accounts in detail and see that they have been drawn as required by the Statute

SHIPPING COMPANIES

The main duties of the auditor in this connection would be—

1 To examine the Articles of Association and any other contract entered into with captains etc

2 To examine the system of internal check existing in the company

3. To see that separate Ledger account is maintained for each ship and separate account is maintained for each voyage

4 To see that the voyage account has been debted with all items of expenses and each voyage is properly charged with the expenditures on stores Such account should be duly credited with the freight and passage money received

5 To see that all the outstanding liabilities with regard to each voyage are duly adjusted and brought into account

6 To vouch the freight accounts with the help of manifests from the agents and advices from the receiving offices Also to check that the provisions have been made for outstanding rebates.

7 To see that the foreign exchange has been correctly adjusted

8 To vouch the insurance policies taken to cover the fleet and the freight in detail It should be seen that the premiums have been properly apportioned over each voyage In case of the time policy it should be seen that the proportion unexpired has been carried forward. Amount received in respect of claims from the insurance companies should be carefully vouched

9 To see that proper depreciation has been charged in respect of each ship

10 To vouch the purchase of the ships and any addition made therein with the help of the contract of sales

11 To scrutinise the items of capital expenditure and see that it has been capitalised and no revenue expenditure has been capitalised It should also be seen that all the expenditures incurred by way of repairs and renewals have been charged to revenue.

12 To examine the charter parties with particular attention to brokerage, commission, and rates of freight and it should be seen that credit has been taken of the agreed returns.

ELECTRIC SUPPLY COMPANY

1. To see that the provisions of Indian Electricity Act, 1910 and the Electricity (Supply) Act, 1948 have been duly complied with.

specially those provisions which affect the accounts

2 To enquire into the system of the internal check

3 To check the Consumer's Ledger with the help of the original records such as meter book for consumption of electricity, register of meters for hire charges, register of fitting on hire, and sales book for the sale of fittings

4 To check the postings from the Consumers' Ledger to the Impersonal Ledger and see that it is being done periodically

5 Vouch the receipts from the consumers with the help of bills and the counterfoils of the receipts Any contract with the consumer with regard to the supply of motive power etc should be duly examined

6 The allowance of discounts given to the consumers should be duly verified and it should be seen that it has been authorised by some responsible officials

7 Enquiry should be made with regard to the arrears on consumer's accounts, specially with regard to those debts which are quite old

8 Any contract entered into with the local authorities for public lighting should be duly examined

9 Allocation of the expenditures between revenue and capital should be duly examined It should be seen that the capitalisation of the expenditures has been made on the basis of the certificate obtained from the engineer.

10 See that salaries of the accountants, engineers, managers, secretaries etc have been properly allotted between generation, distribution and management departments The basis of apportionment should be proper and consistent

11 See that the prescribed provision for depreciation has been made

12 See that the Statutory Reserves have been created as prescribed

13 Check the Stores Book in detail

14 See that the annual accounts have been prepared in accordance with the provisions of the Indian Electricity Act, 1910, Electric (Supply) Act, 1948 and Schedule VI of the Companies Act, 1956

COAL COMPANY

1 The system of internal check existing should be duly enquired into with special reference to the recording and payment of wages

2 Examine in detail all the capital expenditures and see that the proper allocation of expenditures between revenue and capital has been made as certified by the Mining Engineer and the Mine Manager.

3 The lease or agreements should be duly examined to see the conditions with regard to the royalty, shortworking and the minimum rent etc Vouching of the royalty paid should be duly made If the royalty has to be received from the sub-lessee, that should also be carefully vouched

4 Examine the condition for the recoupment of the shortworking out of the future surplus and see that the Balance of the shortworking, until totally recouped, is shown in the Balance Sheet as an asset

5 All the sales must be verified with the help of the Sales Agents' Accounts To ascertain the rates charged the contracts with the consumers, such as railway company, electric companies etc. should be examined

6 With regard to the provision of depreciation, the Articles of Association should be consulted and see that adequate provisions for depreciation has been made as required by the Articles

7 The stock of coals and stores should be duly verified at the end of the year and the basis for their valuation should be duly ascertained

8 A comparison may be made between the figures of output of the coal of the current year with that of the previous years

9 It should be ascertained that no liabilities have been omitted from being brought into the accounts.

10. If the wagons utilised by the company have been obtained on hire purchase system, it should be seen that the instalments paid have been correctly apportioned between the revenue and capital, and depreciation on such wagons has been charged on the total cash value of the wagon and not on their instalment value.

BUILDERS AND CONTRACTORS

The auditor will have to consider the following points in connection with the audit of such concerns —

1 Enquire into the system of internal check prevailing in the concern, specially with regard to the preparation of the wage-sheets and the payment of wages to the workers

2 Ascertain whether any system of cost accounts is being used by the concern, specially the system of dealing with expenditures on stores, materials and allocation of indirect expenses If proper cost accounts are maintained it should be seen how far they agree with the Financial Accounts

3 Enquire into the system of issue of stores and materials to the various contracts. It should be found out how the records of such receipts and issue of stores and materials are maintained Ascertain also the system of dealing with the materials returned from such contracts or jobs.

4 See that separate account is opened for each contract and there is proper allocation of amount of wages, materials and stores and other charges

5 The transfer of machinery from one contract to another is properly recorded and if any particular plant is used exclusively for one job, the depreciation should be charged to that particular Contract Account

6 See that there is proper allocation of wages to the different contracts as certified by some responsible official

7 See that the work in progress, representing the value of uncompleted contracts at the date of the Balance Sheet, has been properly valued Obtain a certificate of the official concerned in his connection or verify it carefully if that is not available

8 See whether the profit has been taken into account with regard to the uncompleted contracts and if it is so, it should be seen that it has been done on the conservative basis It will be safe if no credit is taken with regard to the uncompleted contracts However, if the profit has been taken into account it should be done after giving due allowance to the contingencies and at least one third of the profit should be carried forward Due regard should also be given to the proportion of cash paid on account

9 Vouch the amounts received on account of contracts with the help of Architects' Certificates

10 Examine the basis of valuation of the stock on hand and see whether only certificate for it is available from some responsible official

11. Ascertain whether the provision for depreciation on Plant and Machinery has been adequately made or not

TRUST AND FINANCE COMPANIES

1 Examine the various provisions of the Memorandum and Articles of Association of the company specially with regard to the object of the company and restrictions on investment of the funds of the company

2 Vouch the purchase and sales of the investments very carefully with the help of the brokers' contract notes

3 It should be ascertained that all the interest or dividends receivable have been duly received and recorded in the books properly

4 Verify all the investments very carefully

5. Enquire into the basis of valuation of the investments As far as possible it should be valued at cost and if the market price happens to be lower, it should be brought down to the same value However, a Trust Company is under no legal obligation to provide for the fall in the value of the investments See that the basis of valuation has been clearly indicated in the Balance Sheet

6 Ascertain that the principal and interest on the sale or purchase of the investments have been properly appointed

7 See that the loss on the sale of investment has been properly accounted for It may be charged to revenue or treated as capital loss depending upon the nature of the investments If the investment has been held as fixed asset with a view to earn income from them, any loss on it would be a capital loss and not be charged to revenue account On the other hand, if the investment has been held with a view to resell, it will be in the nature of floating asset and any profit or loss on the sale of such investment should be transferred to Profit and Loss Account

8 Ascertain whether the company holds any partly paid shares and see that the contingent liability in respect of calls not yet made has been stated on the Balance Sheet

9 See that the underwriting commission earned by the company, if any, has been set against the cost of the shares which it had to take to fulfil the commitments and that it has not been taken into account as profit

10 Ascertain that the provision for the depreciation of investments has been adequately made Due regard should be given to the provision of Section 205 of the Companies Act, 1956 Provision of depreciation of the investment, if held as fixed asset by a trust company, is not legally necessary, though it is financially necessary to depreciate it But the provision for depreciation must be made on the investment held as floating or current asset and it must be valued in such case either at cost or market value whichever is lower at the date of the Balance Sheet.

NEWSPAPERS, PERIODICALS AND PUBLISHERS

1 Vouch the Advertising Day Book very carefully and ascertain that no dummy advertisement has been included in it The amount received by way of advertisement and the subscription should be duly vouched

2 Ascertain the details of arrangement made with the agents with regard to charging out the copies sent to them and copies returned from them when they have not been sold It should be seen that proper check is enforced with regard to the unsold copies returned and that proper records have been made for the same or provisions have been made for those estimated to be outstanding

3 Ascertain that all the unexpired subscriptions and the amounts received with regard to the advertisement in advance have been duly included and carried forward

4 Agreements entered into with the authors should be examined, specially with regard to the payment of royalties to them

5. Vouch the payment made to the contributors with the help of the acknowledgment received from them

6 Examine the Establishment Account maintained, if any, very carefully and see that all the items in it have been properly dealt with

7 See that Production Account has been properly maintained with regard to the publication work Separate Production Account should be opened for each work It should be debited with the cost of the copyright, provided it has been purchased, together with the prime cost of production such as editing, compiling, indexing, setting up type and blocks etc

8 See that provisions have been made for all outstanding royalties, commission to selling agents or amounts due to the contributors In case advance payment of royalty has been made to the author and the book is not able to command the desired amount of sale resulting into a loss, it should be written off, as customarily it is not returnable by the author

9 Ascertain that due provision has been made in respect of any suit for libel etc. pending against the company

10 See that the stock of unsold books has been valued at cost but if the publication fails to command sales, it should be written down considerably

11 See that the copyright has been valued from year to year It should never be written up but if the publications for which the copyright has been obtained are not saleable, it should be written off

12 If the publication has been done at the author's risk, see that the unsold stock of such books should not be included in the general stock

13 See that the amounts received on sale of the old types or papers etc have been duly certified

14 See that provision for depreciation on types and printing machinery has been adequately made

THEATRES AND CINEMAS

1 Enquire into the system of internal check with regard to the cash taken for reserved and unreserved seats, cash received on account of the advance bookings, and for the preparation and payment of wages, etc

2 Verify the entries made in the Cash Book with regard to the total of the daily returns of tickets sold and the cash received for the same

3 See that all the capital expenditures incurred have been correctly dealt with in the accounts

4 See that total cost of each production has been spread over the income of such production The money spent on scenery for a particular production also should be charged to the income earned from such production

5. Vouch the receipts from the advertisement with the help of Advertisement Book and contracts Vouch the receipts from the sale of programmes carefully Receipts from the sale of snacks like chocolates, ice bars etc , should also be vouched

6. Vouch the expenses incurred on advertisement and other operating expenses and see that there is proper allocation of the total expenditure between revenue and capital

7. Inspect the agreement for purchase, hire or sub-letting of the films and vouch the advances paid to the producers and distributors etc for hiring the films, with the help of the contracts entered into with them

8 See that the proceeds by way of entertainment tax have been correctly dealt with

9. If it is a touring company, vouch the receipts from it with the help of the returns submitted by the manager Travelling and other expenses should also be vouched accordingly

10 Depreciation on fixtures and furnitures etc , should also receive his attention and it should be seen that adequate provision has been made for the same In case of a theatre company, the depreciation of wardrobe materials, dresses and scenery etc , should also be scrutinised

HOTELS

1 Enquire into the system of internal check with regard to the receipts of cash and accounting thereof by the waiters or cashiers etc , the account for wines, provisions or stores etc and the amount to be charged from the visitors and the records thereof.

2 Vouch the cash received from the visitors from the Cash Book into the Window Ledger. The copies of the bills issued to the visitors for payment should also be examined for the purpose The records entered into the visitor's Ledger with regard to each visitor should be carefully examined

3. Check the receipts of bar, billiard room, or from casual visitors for wines, meals etc in detail and carefully

4 Vouch all the purchases made with the help of the invoices and see that no revenue expenditure is capitalised and the capital expenditures have been correctly recorded in the accounts

5 If several Petty Cash Accounts are maintained, it should be carefully vouched.

6 See that the wages and salaries etc , have been properly certified and paid

7 Verify the stock of provisions, wines, cigarettes, stores etc at the date of the Balance Sheet.

8 See that adequate provisions have been made in respect of the depreciation of fixtures and fittings, bed and table linen, cutlery, glass, utensils and crockery etc

HOSPITALS

1 Vouch all the moneys received with the help of counterfoils of the Receipt Books into the Cash Book

2 Examine that the receipts from other sources such as interest, dividends and rents etc., have been properly accounted for

3 Ascertain that all the donations and subscriptions etc, have been duly acknowledged and accounted in the books

4 Enquire that the funds received for any specific purpose have been utilised for that purpose only

5 Ascertain that the moneys received by way of grants from the Local Authorities and other Government bodies have been duly accounted

6 See that all the purchases made have been duly authorised by the responsible authority and properly accounted

7 Verify the stock on hand at the date of the Balance Sheet carefully

8 See that the expenditures have been properly apportioned between revenue and capital

9 Vouch the payment of salaries to the staff carefully

10 See that adequate provisions have been made for the instruments, apparatus and beds etc

DOCTORS

1 Enquire into the system of recording visits, the patients attended, and check upon the staff

2 Vouch all the cash received from the visits as well as from the patients attended at the clinic carefully with the help of patients register maintained

3 Amount received from the sale of drugs etc should also be carefully vouched with the help of the counterfoil receipt books

4. Vouch all the purchases of drugs and appliances made with the help of invoices

5 Capital expenditures incurred for the purchase of the instruments and apparatus etc, should also be examined and it should be ascertained that it has not been charged to revenue

6 Vouch the salaries of staff paid to them carefully

7. Verify the stock of drugs etc at the date of the Balance Sheet

8 See that adequate provision for depreciation has been made on the instruments and apparatus and the car, if used for the practice purposes

CLUBS

1 Enquire into the system of check applied with regard to the wines, cigars, cigarettes, foodstuffs and the stores etc

2 Acquaint with the rules and regulations of the club specially those which affect the accounts of the club

3 Vouch all the receipts from the entrance fees and the subscriptions from the members with the help of counterfoil receipts and the registers of members

4 Vouch the receipts in regard to the bar, billiard room and catering etc

5 Vouch carefully the receipts in respect of drama or annual dinner etc, with the help of counterfoil receipts, the tickets issued and other records available for the same

6 The arrears of subscriptions should be properly scrutinised and see that it has been properly dealt with in the accounts

7 Examine similarly the subscriptions received in advance from the members and see that it has been only adjusted

8 Vouch all the purchases made in respect of sports goods, wines, cigarettes, cigars and foodstuffs etc, and see that it has been properly authorised

9 Verify the stocks on hand and investment at the date of the Balance Sheet carefully

10 Ascertain the adequate provision has been made in respect of depreciation of furniture, linens, crockery, glass and the premises etc.

EDUCATIONAL INSTITUTION

1 Examine the Trust Deeds, if any, specially with regard to the provisions, affecting the accounts of the institution In case of the University, the relevant Act its statutes should be examined

2 Ascertain the system of keeping the accounts etc, and go through the proceedings of the minutes of the meeting of the governing body or managing committee, specially those related with the accounts

3. Obtain a copy of the budget sanctioned or the financial statement or acquaint with the different heads of income and expenditures of the institutions.

4 Vouch all the receipts by a way of monthly fees from the students with the help of the carbon copy of the receipts and the

Registers of Students into the Cash Book See whether the cash received is banked daily or not

5 Verify the grants-in-aid from the Government carefully

6 Vouch carefully collection of other charges from the students such as examination fees, laboratory fees and other charges Special attention should be paid to the collection of fines imposed upon the students

7 Ascertain that the fees received in advance have been properly dealt with

8 Ascertain that exemption from fees and other charges granted to the students has been duly authorised by proper authority and any charges irrecoverable have been written off when duly authorised.

9 See that moneys received for a particular purpose have been utilised for the same

10 Donations received from different bodies or persons have been duly acknowledged and recorded properly in the accounts.

11 Income from the properties, buildings and other lands should be duly vouched

12 All the establishment expenses should be carefully vouched in detail and the capital expenditures should draw his special attention with a view to ascertain that it has been properly dealt with in the accounts

13 Vouch the amount of salaries paid to the staff from the Salary Register If necessary, the agreements with the employees may be examined Increment in the salary should be carefully scrutinised and it should be ascertained that it has been duly sanctioned

14 The provident fund of the staff should be duly checked and it should be seen that it has been properly invested

15 Check the payments made on account of scholarships with the help of the receipts from the students therefor and the Scholarship Register

16 Verify the stocks of furnitures, equipments, stationery provisions etc very carefully Special attention should be paid to the stock of books and equipments in the laboratories etc

17 See that all the assets and liabilities have been duly brought into account

CHARITIES

1 Examine the constitutions of the charitable institution its legal status and rules and regulations governing it If the charity is a public one the provisions of the State legislations should also be carefully noted

2. Inspect the minute book of the trustees or the executive body to ascertain the transactions affecting the accounts.

3 Vouch all the receipts and subscriptions entered in the Cash Book with the help of the counterfoil Receipt Book and also with the help of the printed Donation and Subscription Lists, if any

4. Ascertain whether any fund was remarked for any specific purpose and see whether it was duly complied with

5 Examine the Trust Deed to see the provisions with regard to the investment or the utilisation of the funds and ascertain that they have been faithfully observed

6 Vouch the receipts from the legacies with the help of the Legacy Register and the correspondence entered into in this connection

7 Vouch the purchase of the investments, and see that it has been done according to the prescribed rules, if any

8 See that the incomes from the investments in the form of interest and dividends etc have been properly brought into account

9 See that no income-tax has been paid on the incomes of the charities since usually their incomes are not liable to tax

10 Verify the assets and liabilities of the charities at the date of the Balance Sheet carefully

11 See that the annual accounts of the charities have been prepared in the prescribed manner, if any

LANDED ESTATES

1 On the first audit of the estate, the auditor should vouch all the acquisitions with the help of the Conveyance Deeds and the Solicitor's Bills of Costs The agreements of the Lease should be examined if the acquisitions are leaseholds On subsequent audit, he should examine the new acquisitions or leases only

2 Examine the Register of Tenants or the Rent Rolls with a view to vouch the rents collected and entered in the Cash Book See that any deductions or allowances have been granted by the proper authority

3 Vouch all the receipts from the sale of the products from the Estate such as stock, timber or game etc with the help of the counterfoil receipt books or other records available

4 Arrears of rents should be duly enquired into, specially those which are due for a long period Such arrears should be checked from one period to another with the help of List of Arrears made out from the Rent Rolls

5 Vouch all the expenses such as insurance, municipal expenses, commissions etc. with the help of the relevant receipts

6. Expenditure incurred for the repairs of building etc should also be vouched and it should be seen that it is duly authorised

7 See that all the outstanding rents have been properly brought into account and carried forward in the Rent Rolls

8. In case of the sale of any property of land by the Estate, the Sales Deed should be inspected

SOLICITORS' ACCOUNTS

1 Examine the Partnership Deed, if it is a partnership firm, specially with regard to those provisions which affect the accounts The rules and regulation laid down by the High Court and in force at that time should also be ascertained

2 See that separate accounts have been maintained force the client's moneys and the funds of the firm

3. Vouch all the cash disbursements made on behalf of the client and entered in the Client's Disbursements Cash Book with the help of the original vouchers

4 Compare the total of the cash balances of the client's money as appearing in the accounts with that of the balance shown in the client's bank accounts and any difference in the balance must be reported.

5 Petty cash disbursements on account of the clients should also be carefully scrutinised and see that it has been properly brought into the accounts

6. Examine in detail the Register of Bills Delivered

7 Check the Clients' Ledger very carefully and see that allowances to customers have been properly recorded.

8. See that all the outstanding liabilities in respect of the fees to be paid to the counsel on behalf of the clients, though charged to the clients, have been brought into account

9 See that the premiums received from the article clerks have been properly apportioned over the term of the articles

10 See that estimated costs of incomplete matters not charged to clients have been taken into account on a conservative basis In case they have not been taken into accounts, see that a note to this effect has been given in the Balance Sheet

RETAIL STORES

1 Enquire into the system of internal check in use with regard to purchases and sales, specially with regard to the handling of cash

2. Vouch all the purchases made with the help of invoices and stock records and correspondence entered into in this connection.

3. Vouch the Cash Book exhaustively and carefully If the bills are given to the customers for the payment to be made at a

separate counter, make a test checking in the assistants' books with the cashier's daily summary

4 Check the balances of the customers account exhaustively particularly when no proper credit control system exists therefor

5 See that adequate provisions have been made for all the bad and doubtful debts

6 Calculate the percentage of gross profit to the sales for the previous two to three years and compare it with that of the current year and make proper enquiry if there is material variation in the percentages

7 Vouch all the expenditures incurred very carefully

8 Verify the stock at the date of the Balance Sheet and seek proper explanations for any shortage in it

WHOLESALE TRADERS

1 Enquire into the system of internal check in operation with regard to the purchases and sales and maintenance of stock.

2 Vouch all the purchases made very carefully with the help of the invoices and other relevant documents and see that purchases returns have been duly accounted for

3 Vouch the sales also exhaustively with the copy of the invoices and see that the sales returns and the allowances given to the customers have been duly accounted In case of foreign sales, also see that the conversion of foreign currency into rupees has been correctly made

4 The trade discounts allowed to the customers should receive special attention It should be seen that it has been allowed at the agreed rate only

5 Ascertain the procedure of dealing with the goods sold on sale or return basis or goods sent on contingent etc and see that it has been properly adjusted into the accounts

6 Expenses such as godown rent, clearing charges, damages paid etc, should be vouched carefully.

7 Find out the balances of the debtors at the end of the period and check it See that debts are not outstanding for a long period, if it is so, enquire into the matter Also see that adequate provisions have been made on bad and doubtful debts

8 Verify the stock at the end of the financial year very carefully with the help of the stock records maintained Examine particularly the purchase, sales and returns of the last month very carefully See that the stock has been valued on the consistent basis and there is no shortage in it

9. Find out the percentage of the gross profit to the sales for the last three years at least and compare it with that of the current year and see if there is any material variation in it If it is so, seek explanations for the same.

BRANCH ACCOUNTS

1 Acquaint himself with the system of accounting employed in the branches and the way it is incorporated in the head office books Ascertain whether there is uniformity in the system of accounting employed by the different branches Also find out the system of internal control applied for recording of various transactions in the branch books

2 Ascertain the terms of engagement precisely specially whether he will have to visit the branches personally or to examine the returns submitted by the branches duly certified by the local auditors.

3 Vouch all the cash remitted from the branch, as shown by the branch accounts into the head office books and similarly vouch all the cash remittances from the head office to the branches into the branch accounts

4 In case the sales moneys are collected by the branches locally, check in detail that all the cash collected has been duly accounted for In case the branch does not collect the sales money and simply reports the matter to the head office, satisfy himself that all the sales by the branch have been properly reported to head office and for this purpose check the Despatch Book exhaustively

5 If the branch maintains complete set of books for the purpose of recording all the transactions carried on by it, the head office maintains simply the current account in respect of each branch, Trial Balance or the Final Accounts of the branch will be available See that proper vouchers are available in respect of the transactions recorded If the local auditor has certified them, there will be no need for the same It should be noted that balance of the current account of the branches will show the capital employed by them and it should be shown as such in the Balance Sheet and should not be included in the sundry debtors.

6 Vouch the branch manager's remuneration very carefully specially when his remuneration has been linked with the profits of the branch and see that the profits have been inflated wrongly with a view to earn more remuneration

7 See that the expenses of the branches are met by the cheque drawn by the head office The head office, should remit necessary amounts to the branch for petty cash transactions The Petty Cash Account should be maintained on the Imprest System.

8 See that the closing stock of the branch has been properly valued The goods may be sent to branches at cost price or at cost price plus a fixed percentage or at marked price or selling price If the goods have not been sent at cost price, it should be ascertained that the stock at the end of the year has been reduced to cost Branch Adjustment Account may be prepared for the purpose.

9 With regard to the branch debtors at close, obtain a certificate from the branch officials and see that it has been duly incorporated in the head office books Also see that all the liabilities at the branch have been duly accounted in the head office books

10 See that all the inter-branch transactions have been properly recorded in the books

11 Examine the adjustments made in the books in respect of cash or goods in transit, and verify that it was subsequently received

12 If the certificates from the branch officials are accepted in respect of the valuation of stock, quantity of stock, balance of the sundry debtors, reserve for bad and doubtful debts etc it should be mentioned in the report to limit his responsibility

13. The question of exchange has to be duly considered in case the branches are located in a foreign country See that conversion of foreign currency into rupee has been correctly made The difference in value of exchange has also to be seen and checked It the exchange rate is stable, the conversion may be made at the fixed rate, but if the exchange rate is fluctuating see that the following rule has been adopted for the conversion, fixed assets are converted at the rate prevailing when they were purchased, current assets and liabilities are converted at the rate prevailing at the close of the financial period, revenue items are converted at the average rate, remittances are converted at the actual rate, the balance of the Head Office Accounts should be replaced by the balance of the Branch Account as shown in the Head Office Books

14 See that all the instructions given by the head office have been duly followed by the branch

DEPARTMENTAL STORES

1 Enquire into the system of accounts employed by the stores See whether it is maintained on the columnar system or not Also enquire into the system of internal check prevailing specially with regard to cash sales, purchases and payment of wages and salaries etc Also acquaint himself with the general organisation and control of the stores

2 Vouch the cash sales with the Cash Memo Books into the Daily Sales Summaries If the sales are enormous, make a test checking.

3 Check the General Cash Book exhaustively with the help of the Sales Summaries

4. Vouch all the purchase made with the help of invoices and see that payment has been made only when the invoices have been duly authorised by some responsible official Also see that all the allowances and discounts obtainable on the purchases made have been taken advantage of

5. Vouch carefully the salaries and wages paid, specially when the commission is payable on the basis of the sales.

6 See that all the inter-departmental transactions have been properly brought into the account

7 See the basis of the distribution of the common expenditures between the different departments See that the basis adopted for the purpose is just and equitable and is followed consistently from year to year

8 Ascertain the percentage of the selling expenses to the total sales in the previous years and seek explanation in case there is material variations in the percentages

9 Similarly apply the gross profit tests also

10 Verify the stock on the date of the Balance Sheet very carefully and see that it has been properly valued Obtain a certificate from the General Manager of the stores in this respect

11 See that adequate depreciation has been made to the building, if owned by the stores, and furnitures and fixtures etc

QUESTIONS

1 What special points would you keep in mind while auditing the accounts of an electricity company ?

2. How would you, as auditor deal with the audit of shipping company

3 Discuss the special points arising in the audit of a coal company

4 How would you, as an auditor, proceed for auditing the accounts of a college ?

5 You have been appointed auditor of a departmental store. How would you audit the same ?

6 As an auditor, how would you audit the accounts of a cinema or hotel ?

7 How would you audit the accounts of (*a*) wholesale trader, and (*b*) retail store

8. What special points would you keep in mind, as an auditor, for auditing the accounts of clubs or charities

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Cost Audit

Cost audit or audit of cost accounts was introduced in India in 1965 by an amendment in the Companies Act, 1956 This has been hailed as a unique provision keeping in view the basic policy of the Government of India to achieve industrial growth with social justice It is to be noted that this is a significant departure from the Company Law as it is operative in various industrially advanced countries of the World Undoubtedly, we have taken a lead in this respect and it has been rightly claimed as "unique, revolutionary and epoch-making" provision introduced in the country

The need for such provision in the Act arose as the maintenance and proper use of scientific cost records is essential for those companies which are engaged in the manufacturing and allied activities, but there has been no proper consciousness of this important fact in the country Even if some large companies maintained such records, they were kept secret and confidential and it was not properly used as a tool of management It is felt, and rightly so, that the management of joint stock companies do not worry to make use of scientific costing as they are earning sufficient profits due to scarcity conditions prevailing in the country They do not feel the need for imposing self regulation in controlling costs with a view to avoid wastage, conserve resources and make their best possible utilisation They have not been making proper use of scientific technique of cost accounting for improving the performance of their concerns They rely heavily on the financial audit, but it is well known that the financial audit, as it is compulsorily carried on by every company, fails to achieve this objective This fact has been clearly pointed out and emphasised by the various committees and commissions, such as, Vivian Bose Commission, the Dutta Commission, the Sastri Committee etc Thus, the basic purpose of this provision has been the creation of cost-consciousness among the management of the joint stock companies in the country.

It is to be noted that, unlike the financial audit, the cost audit has not been made compulsory for every company It is compulsory only for certain specified categories of companies which are specifically asked to do so by the Government. The Government can pass necessary orders for the purpose only for the following types of companies :

(*a*) those required to maintain the cost accounts under Section 209 (d), and

(*b*) those companies which are engaged in the manufacturing, processing and mining activities etc.

Even for the above companies, all of them are not required to get their cost accounts audited, but only those which are specifically asked to do so

ARGUMENTS AGAINST COST AUDIT

Several arguments have been given against the introduction of cost audit in the country. Chief of them has been briefly put as follows

(*i*) Government has been imposing several restrictions on the working of the companies in the country and the introduction of the cost audit has added one more restriction, which may prove to be quite harsh on the management of such companies This would unnecessarily mean interference in the working of such companies

(*ii*) This would mean that such companies would be required to have two sets of auditors, one for the financial audit and the other for the cost audit It would result in duplication or overlapping of the work of the audit.

(*iii*) It is true that a large area is common between the financial audit and the cost audit and if both of them is carried on, it may lead to conflicting situation

(*iv*) It is argued that there is no need for the cost audit when the financial audit is compulsory for all the companies The financial auditor thoroughly audits the accounts of those companies also which have been brought under the purview of the cost audit

(*v*) It is also argued that such companies are already maintaining cost accounts and the cost accountant is there to look into the affair The duties of the cost accountant are almost the same as that of the cost auditor This would also mean duplication of the work.

(*vi*) Some authorities have stated and rightly so that there is shortage of experts in the field of cost accounts or cost audit in the country and, undoubtedly, too much is expected of the cost auditors A perusal of the Cost Audit (report) Rules gives one a feeling that the cost auditor would not be able to fulfil the required formalities

(*vii*) It would mean an additional cost to the companies concerned and it has been even termed as "expensive luxury" by some authors

(*viii*) It has been claimed that the benefits expected from the cost audit might not commensurate with the time and cost involved in it It would unnecessarily involve long period of time to carry on the cost audit and the provision that a report must be made within 60 days before the date of the general meeting is quite unrealistic.

(*ix*) One important argument put against the cost audit is that the examination of cost records by an external specialist might lead to the risk of secrecy of data being lost

Much of the above arguments placed against the introduction of cost audit is ill founded and do not have enough force The arguments have been placed due to misunderstanding of the nature and purpose of the cost audit It is wrongly argued that it would mean interference in the working of the management of such companies As a matter of fact, it would be very much useful to them as mentioned later and the cost auditor would not be there simply to find faults or offer criticisms He would be there playing a constructive role and offering valuable suggestions to them for bringing improvement and efficiency As to the duplication of the work between the financial and cost audit, the argument that there would be duplication of work between the financial and the cost audit, is also not correct once the nature and the difference between the two is clearly understood The argument, that when a cost accountant is maintaining the cost records there is no need for the cost auditor, is also not very sound In this connection, the role of the cost accountant and the cost auditor should be clearly understood The function of the cost auditor is undoubtedly more important than that of the cost accountant The latter is an important member of the whole management team and supplies relevant data regarding the actual costs along with the deviations from the predetermined norms or standards, whereas the former tries to ascertain the causes leading to such deviations and their impact on the existing production and pricing policy The cost auditor is in a better position to offer constructive suggestions to the management As regards to the availability of the experts for the purpose we have already two important Institutes training Cost Accountants and the Chartered Accountants and there would be no paucity of experts for the purpose in near future To a certain extent it may be true that the cost audit would involve time and money but once the procedure for maintaining proper cost records is correctly understood and duly followed there would be no difficulty in completing the audit of the cost records and submitting the report within 60 days before the date of the general meeting The apprehension, that if external specialist would carry on cost audit the secrecy of the cost data would not be maintained, is quite baseless The Tariff Commission has already been examining the cost data of various companies from time to time and so far there has been no complaint that the data have leaked out The secrecy of the data has been strictly maintained and in case of cost audit also it would be possible

The provision for the cost audit has been introduced by the introduction of the Clause (d) to Section 209 and 233 B to Section 233 It would be pertinent to quote them here

Section 209 (I). Every company will keep at the Registered

Office proper books of account with respect to

(*a*) * * * *

(*b*) * * * *

(*c*) * * * *

(*d*) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account

Section 233 B

(1) Where in the opinion of the Central Government it is necessary so as to do in relation to any company required under clause (d) of sub-section (1) of Section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor, who shall be either a Cost Accountant within the meaning of Cost and Work Accountants Act 1959, or any such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 or other person as possesses the prescribed qualifications

(2) An auditor under this section shall be appointed by the company in general meeting and the provision of Section 224 shall apply, as far as may be, in relation to such auditor as they apply in relation to an auditor appointed under that section

(3) An audit conducted by an auditor under this section shall be in addition to an audit conducted by an auditor under Section 224.

(4) An auditor shall have the same powers and duties in relation to an audit conducted by him under this section as an auditor of a company has under sub-section (1) of Section 227 and such an auditor shall make his report to the Company Law Board in such form and within such time as may be prescribed and shall also at the same time forward a copy of the report to the company

Under the Companies (Amendment) Act, 1974, certain amendment has been made in Section 233 B In place of words "Who shall be either a Cost Accountant . as possesses the prescribed qualifications" have been substituted by "who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959.

However, there is a proviso to this that "if the Central Government is of the opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959, are not available for conducting the audit of the cost accounts of companies generally, that Government may, by notification in the Official Gazette, direct that, for such period as may be specified in the said notification, such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualifications, may also conduct the audit of cost accounts of companies, and thereupon a Chartered Accountant possessing the prescribed qualifications may be appointed to audit the cost accounts of the company "

Thus, after the amendment in the Act in September 1974, normally it is the Cost Accountants who are competent to conduct the cost audit of the specified companies If the sufficient number of the Cost Accountants is not available, only then the Government may allow the Chartered Accountants to take up this task of cost audit for a specified period

The sub-section (2) of the Section has also been amended and now the approval of the appointment of such auditor has to be taken from the Central Government Now it reads as follows "The auditor under this section shall be appointed by the Board of directors of the company with the previous approval of the Central Government

In sub-section (4) also, the words "Company Law Board" have been substituted by the words "Central Government" It means that earlier the cost auditor was required to submit his report to the Company Law Board and now he has to submit the same to the Central Government

By the same amendment in the Act, seven new sub-sections have been added to the Section 233 B They are as follows

(5) (*a*) A person referred to in sub section (3) or sub section (4) of section 226 shall not be appointed or re appointed for conducting the audit of the cost accounts of a company

(*b*) A person appointed, under section 224, as an auditor of a company, shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company

(*c*) If a person, appointed for conducting the audit of cost accounts of a company, becomes subject, after his appointment, to any of the disqualifications specified in clause (a) or clause (b) of this sub section, he shall, on and from the date on which he becomes so subject, cease to conduct the audit of the cost accounts of the company

(6) Upon receipt of an order sub section (1), it shall be the duty of the company to give all facilities and assistance to the person appointed for conducting the audit of the cost accounts of the company.

(7) The company shall, within thirty days from the date of receipt of a copy of the report referred to in sub-section (4), furnish the Central Government with full information and explanations on every reservation or qualification contained in such report

(8) If, after considering the report referred to in sub-section (4) and the informations and explanations furnished by the company under sub-section (7), the Central Government is of opinion that any further information or explanation is necessary, that Government may call for such further information and explanation and thereupon the company shall furnish the same within such time as may be specified by that Government

(9) On receipt of the report referred to in sub section (4) and the informations and explanations furnished by the company under sub section (7) and sub-section (8), the Central Government may take such action on the report, in accordance with the provisions of this Act or any other law for the time being in force, as it may consider necessary

(10) The Central Government may direct the company whose cost accounts have been audited under this section to circulate to its members, along with the notice of the annual general meeting to be held for the first time after the submission of such report, the whole or such portion of the said report as it may specify in this behalf

(11) If default is made in complying with the provisions of this section, the company shall be liable to be punished with fine which may extend to five thousand rupees, and every officer of the company who is in default, shall be liable to be punished with imprisonment for a term which may extend to three years, or with fine which may extend to five thousand rupees, or with both

Thus, through the amendment, as mentioned above, it has been made clear that only cost accountant would conduct the cost audit This has provided that necessary facilities have to be given by the company to such an auditor It has also provided for the punishment in case of default

DEFINITION OF COST AUDIT

The cost audit is concerned with the audit of the cost records with a view to find out whether the cost accounts have been properly maintained according to the general principles of costing According to Walter W Bigg, it is "the verification of the correctness of cost accounts and of the adherence of the cost accounting plan " Thus, it not only involves the examination of the cost accounts but also the fact that the plan prepared in this connection has been duly executed.

It has been defined in similar fashion by the Institute of Cost and Works Accounts of England, and R W Dobson

Smith and Day, in their book entitled 'Advanced Accountancy' state that "By the term 'Cost Audit' is meant the detailed checking

of the costing system, technique and accounts to verify their correctness and to ensure adherence to the objective of cost accountancy" They have emphasised that it does not involve only examination of cost accounts but also the costing system and technique They have rightly emphasised that the purpose of such audit is to see that the objective of cost accountancy has been fulfilled or not

Thus, cost audit is concerned with the examination of the cost records, cost system and technique and its purpose is to see whether the cost accounting plans have been duly adhered to or not It is carried on with a view to verify duly whether the records related to the cost accounts are arithmetically correct or not and there is no omission in that respect Its purpose is also to detect errors or frauds, if any

DIFFERENCE BETWEEN FINANCIAL AUDIT AND COST AUDIT

The difference between the financial audit and the cost audit must be understood clearly In principle, both differ materially though techniques adopted may be similar The former deals with the general accounts of the company with a view to find out whether the accounts of the company have been properly maintained and whether the balance sheet and the profit and loss account show true and fair view of the affairs of the concern audited, while, in case of the latter, the cost auditor is mainly concerned with the audit of cost accounts The main points of difference between the two are as follows

(*i*) Financial audit is compulsory for all the companies under the Companies Act, 1956, whereas the cost audit is not compulsory for all the companies The latter is compulsory only for specified and limited number of companies

(*ii*) The area of the financial audit is a bit limited as compared to that of the cost audit The cost audit is carried on with broader objectives, therefore, its area is also wider

(*iii*) The object of the financial audit is to see that the books of accounts have been properly maintained and that the balance sheet and the profit and loss accounts show a true and fair view of the affairs of the company. The object of the cost audit is different and it is carried on with a view to see that the expenses have been incurred properly and wisely in the best interest of the company and to verify and examine the unit cost of production

(*iv*) The financial auditor depends upon sample checking and the test audit of the books of accounts including the cost records, but he does not go into the details of the cost records But the cost auditor has to examine the cost records thoroughly

(*v*) The financial auditor is concerned mainly with the financial aspect of the accounts audited whereas the cost auditor is concerned with those aspects of the accounts which are mainly related to the cost This makes the approach of both the audits much different

(vi) The cost auditor does not examine the financial ledger such as, debtors, creditors, capital, bills etc whereas the financial auditor must see them However, the cost auditor is concerned with the stock records and has to find out whether stock is in accordance with the needs of the concern or not The financial auditor, however, is concerned mainly with the valuation and verification of the stock Similarly, the financial auditor has nothing to do with the costing of the issue of raw materials or labour etc whereas the cost auditor must examine them

(vii) The cost auditor has to guide and serve the interest of the management of the concern whereas the financial auditor is there to serve the interest of the shareholders mainly.

(viii) The appointment of the financial auditor is made by the shareholders in the general meeting of the company but the appointment of the cost auditor has to be made by the Board of Directors

(ix) There is no need for seeking prior approval of the Central Government with regard to the appointment of the financial auditor but in case of the cost auditor the previous approval of the Central Government is necessary

(x) The financial auditor has to submit his audit report to the management of the company whereas in case of the cost audit the report has to be submitted to the Central Government

ADVANTAGES OF COST AUDIT

The cost audit offers several advantages specially to the management of the company Some of the chief advantages which may accrue due to the cost audit have been mentioned briefly below:

(i) It gives the management of the company a detailed insight into the costing of the various operation of the company Through various valuable advises and suggestions available from the cost auditor, the management may be in a better position to control the affairs, specially cost of production, of the company

(ii) It may give a definite clue to the productivity or efficiency of the different factors of production and corrective measures may be taken timely if there is some lacuna in this respect

(iii) It may help in making comparison of the unit cost of production of different plants, departments, or sections under the same management properly

(iv) It enables the management in finding out the correct cost of production which helps them in fixing the price This would also help in submitting quotations when a tender is invited.

(v) It would enlist the area wherever there is a wastage of material or labour or both and then it would be easier for the management to control the same

(*vi*) It would facilitate the management in fixing the responsibility of the individuals in case of in efficiency, less productivity, wastage, pilferage or theft etc

(*vii*) Through the comparison of inter-unit cost data, if it is found out by the management that some of the units are highly inefficient, it may take corrective measures to improve the situation and if that is not possible it would help them in taking a decision whether that unit should be allowed to continue or be closed down

(*viii*) It would enable the management as well as the financial auditor in correct evaluation of the stock which is definitely not an easy job as mentioned earlier

(*ix*) It would enable the financial auditor to understand and depend upon the cost data while examining them.

(*x*) It would be of great help to the internal auditor of the company also as with the facts thus available to him he would be in a better position to control the affairs

(*xi*) It would help the management in preparing workable plan, so essential, with the help of the verified cost data and other information available to them.

(*xii*) It is quite useful from the point of consumers and Government. It helps the Government in fixation of price, controlling the price, deciding whether or not tariff protection should be extended etc It is also quite helpful when there are shortages in the economy and price control has to be imposed It helps authorities in levying tax or duty on the cost of finished goods Consumers stand to gain as reasonable price may be fixed, as well as, profiteering during the period of scarcity may be curbed easily

APPOINTMENT OF THE COST AUDITOR

Earlier, it was provided that the cost auditor would be appointed by the shareholders in the annual general meeting as in the case of statutory auditor appointed under the Section 224 But now after the amendment of the Companies Act in 1974, it has been provided that the cost auditor is to be appointed by the Board of Directors of the company with the previous approval of the Central Government Earlier, it may be noted there was no need for the prior approval of the Central Government for the purpose

The remuneration of the cost auditor, however, is to be fixed by the company

QUALIFICATIONS OF COST AUDITOR

Earlier, it was provided that either Cost Accountants or the Chartered Accountants were duly qualified for carrying on the cost audit, but now the position is changed after the amendment of the

Companies Act, in 1974 Now it has been clearly provided that only a cost accountant within the meaning of the Cost and Works Accountant Act, 1959, can act as cost auditor The Chartered Accountants, now, cannot undertake the cost audit normally Only, under the exceptional circumstances, when the sufficient number of the cost accountants are not available for the purpose, the Central Government may, by notification in the Official Gazette direct the chartered accountants also to carry on the cost audit for a specified period

RIGHTS AND POWERS OF COST AUDITOR

The rights and powers of the cost auditor is also the same as available to the statutory auditor and as specified under Section 227 (1) of the Companies Act, 1956, described in an earlier chapter. Under the Companies (Amendment) Act, 1974, the cost auditor has been given full rights to receive all the facilities and assistance as may be necessary for conducting the audit of the cost accounts of the company

REPORT

A cost auditor is required to submit his report to the company concerned as well as to the Central Government Earlier, he was required to send the report to the Company Law Board but by the amendment of the Act in 1974 it has been provided that he has to send his report to the Central Government and not to the Company Law Board

While drafting his report, the cost auditor must see that he puts the facts in the report very precisely He is required to perform a very important duty while he conducts the audit of the cost records and he must be very careful in finding out the facts and reporting the same properly and clearly He must give his reservation or qualification, if any, very carefully and precisely, as, later on, the Central Government seeks necessary informations and explanations on such reservation and qualifications. He has to be bold enough to bring forth all the facts in his report and there should be no hesitation on his part in disclosing the defects, defaults, irregularities, discrepancies etc even if the management of the company is involved in the same. He must perform his duties in right earnest and honestly

There is a time limit for sending the report It must be sent to the Central Government within 120 days from the end of company's financial year to which the cost audit report relates Every officer of the company is required to make available to the cost auditor all the records and statements within 90 days from the end of financial year so that he may finish his work and send the report within 120 days

Form of the Report

The report has to be submitted by the cost auditor in the following form, as prescribed in a schedule annexed to the Rules

"I/we* . . having been appointed as auditor(s) under Section 233 B of the Companies Act, 1956 (hereinafter referred to as the "Cost Auditor(s)" of Messrs Ltd '(hereinafter referred to as the company) have examined the books of accounts prescribed under clause (d) of Sub-section (1) of section 209 of the said Act and other relevant records for the year ended relating to maintained by the company and report, subject to my (our comments under the heading "auditor's observations and conclusions, contained in the Annexure to this report, that

(*a*) I/we have/have not obtained all the information and explanation which to the best of my/our knowledge and belief were necessary for the purpose of the audit,

(*b*) proper cost accounting records as required under clause (d) of sub-section (1) of Section 209 of the Companies Act, 1956 (1 of 1956) have/have not been kept by the company,

(*c*) proper returns adequate for the purpose of my/our cost audit have/have not been received from branches not visited by me/us,

(*d*) the said books and records give/do not give the information required by the Companies Act, 1956 in the manner so required, and

(*e*) in my/our opinion the company's cost accounting records have/have not been properly kept so as to give a true and fair view of the cost of production, processing, manufacturing or mining activities, as the case may be, and marketing of the product under reference

The matters contained in the Annexure to this report form part of this report, which is also subject to my/our observations made therein

Dated this day of 19 at .
Cost Auditor(s)

QUESTIONS

1. What is cost audit ? Discuss its advantages and limitations
2 Define cost audit and distinguish it clearly from the financial audit.

*The inapplicable words may be deleted at all places in the report

3 Discuss the provisions of the Companies Act, 1956 regarding the cost audit and explain the advantages of cost audit

4 Explain the appointment, qualifications, rights and duties of a cost auditor

5 Give a specimen of the form of the audit report to be submitted by the cost auditor

6 Discuss the concept and object of cost audit and state who can conduct it under the Companies Act, 1956 ?

7 If called upon to conduct cost audit of a company, state briefly how would you proceed ?

*For answers, refer to questions no. 89 and 90

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Investigation of Accounts

Besides regular audit of the books of account of a business concern, there may arise the necessity for thorough examination of the accounts and records of past several years to meet certain special ends from time to time Under such circumstances, the investigation of accounts is carried on It implies an inquiry into the accounts and records of a business concern In most cases, the purpose of such inquiry is to ascertain the true financial position of the concern or its normal profit-earing capacity or the extent of fraud, if any, or to inquire about the suspected mismanagement etc Thus it is a special kind of examination of account or records carried on by an investigator with a pre defined purpose according to the necessity of the situation and entails something more than the verification of accuracy of figures of the Balance Sheet

Difference between Investigation and Audit Investigation of accounts should not be taken to be synonymous with the audit of accounts It may be taken to be a special kind of audit done with special purpose "It differs from an audit in as such as it is not primarily carried out for the purpose of ascertaining whether a Balance Sheet is properly draw up but rather for the purpose of obtaining information of a particular nature required by a client or, in the case of investigation of fraud, for the purpose of ascertaining its extent" We give below the various points of difference between the two

(*i*) An audit is carried out on behalf of the proprietor of the business only but an investigation may be carried out on behalf of the proprietor or on behalf of other third parties also It may be carried out on behalf of the prospective purchases of the business or the prospective shareholders or the Government or the Court or the proprietors themselves.

(*ii*) The investigation of books of account and records is not legally compulsory but audit is compulsory statutorily in case of joint stock companies

(*iii*) The object of audit of accounts is to ascertain whether the Balance Sheet of the concern exhibits the true and fair view of the state of affairs of the concern or not But the object of investigation differs according to the needs, or, say, it is carried on with special purpose

(*iv*) Investigation is usually carried on when the books of account are already subjected to regular audit but it is not so with regard to audit except in the case of special audit of a joint stock company under section 233 A of the Companies Act, 1956

(*v*) The period for which the accounts are subject to examination also differ in both the cases In case of audit the period is usually one financial year but in case of investigation on the examination extends to a period of more than a year, usually three to seven years, depending upon the purpose with which the investigation is carried out

(*vi*) They differ from the point of depth of examination also In case of audit it is usually carried out in the form of test checking but it is not so in case of investigation The latter covers not only thorough, minute and critical examination of the accounts and records of a concern, but also thorough enquiry about the factors which led to the particular circumstances of the concern It also involves probing deep into the matter and looking for the required information far behind the books whenever necessary It may necessitate extending the examination for something much more than the mere figures recorded in the books of accounts and other records

(*vii*) Under investigation it may become necessary to make certain adjustment in the annual accounts already prepared and audited but this is not so required in case of audit

(*viii*) Auditing can be conducted by a practising C A , but it is not necessary that an investigator must be C A

To quote R A Irish, "While auditing procedure may be adopted for a great deal of the work, in investigations an investigator must approach his work in a critical and perhaps suspicious state of mind He may be deeply concerned about what should have been done rather than confirmation of what has been done. Furthermore, he may be intensely interested in questions of policy, a problem which is legally outside the scope of an auditor's liability"

Duties of an Investigator There are several points which have to be kept in mind by an accountant called upon to carry on investigation' He should take care to obtain from his client clear instructions in writing as to the purpose of investigation and the period which has to be covered He should also find out whether any limit has to be imposed upon its scope If definite instructions have been given with regard to the scope he has not to bother much about this and should proceed accordingly In the absence of any express and clear instruction with regard to the scope of his work, it is for him to decide the extent and scope of his investigation His decision, of course, will be based on the nature and purpose of investigation, the nature of business, the system of internal control obtaining at the time in the client's concern, the manner in which the books of account are kept, etc He should keep in mind that the report of investigation which he will submit will be relied upon and utilised by the proprietors and others.

Usually the investigation of accounts is carried on after the books of account are already subjected to the regular audit Under such circumstances, the work of the investigator is a bit simplified since he can work on the assumption that the accounts will be correct, at least, arithmetically He can also make use of the auditor's report He may not have to undertake the detailed checking which usually is undertaken in course of that audit But he should realise that the scope and methodology of the work are different than that of an auditor depending upon the nature of the job and the purpose with which the investigation is carried on At certain places he may have to probe the matter deeply and intensively

It is also desirable to ascertain the general reputation of the promoters, vendors or other parties not known to him It will help him in the process of investigation a great deal He should discuss with the previous auditor, if any Where necessary, he should also consult the experts and obtain a certificate from them in related matter

He must approach his work methodically. He must work honestly and diligently He must keep the interest of his client at the top and must work with a feeling of some service to his client The subject of the investigation is of highly technical nature and usually the senior accountants with perfound knowledge and experience are employed for the job He need not be a Chartered Accountant but he must have sound knowledge of accountancy and auditing and practical knowledge about the various affairs of different types of concerns He must be better equipped than any professional auditor He must be a man of competence and ability to understand the different matters clearly He must possess the ability to grasp things easily and express them in clear words He must be a man capable of exerting influence rather than being led away by others He must weigh down all the points before drawing his conclusions of the investigation but his decision should not bear the imprint of influence from others While conducting the investigation, he must exert utmost care, skill and reasonable diligence, keeping in mind all through the purpose of investigation

He must take care to preserve all the working papers and notes made during the course of investigation for a reasonable period He should keep in his possession the papers regarding inquiries, explanations sought, adjustment made and all other data and the informations which he gathers during the investigation If he does not care to do so, it may cause unnecessary worry and duplication of work if in future there arises any need for such references, specially when evidence has to be given in the court in the event of any dispute

The most important part of the work of investigation is to draw the conclusions arrived at and draft a report for presentation to his client He must not be tempted to write his report as early as

possible, neglecting the main points to be dealt within it He must, weigh down all the points which he gathers during the course of investigation and see that the schedules are completed and the figures are reconciled before the report is drafted He must draft his report with utmost care and precision Any haste in drafting his report and consequent misleading statement in it may make him liable for damages caused to his client He should bear in mind that his report may be relied completely by the client as well as other parties and any erroneous or misleading statement in it may cause damage to them

His report should be drafted carefully It should contain all important and relevant matters It should be properly classified The investigator should mention in it the instructions given to him by his clients with regard to the investigation He must mention the limits, if any, put in the scope of his work If he does not want to assume any responsibility with regard to the accounts which he was not called to examine, he may qualify his report accordingly He must write in clear words all the work done in this connection and the conclusions arrived at But he must give the comparative statements and other schedules in support of his conclusions He must present in his report what is essential, ignoring what is not essential Facts and only facts should be presented and nothing based on estimates should be given Only precise and definite conclusions should be given in the report However, he should not make unnecessary delay in drafting his report when the work is over, because the things are fresh in his mind at that time

DIFFERENT CLASSES OF INVESTIGATION

The principal classes or objects of investigation usually carried out in practice are as follows

(*i*) On behalf of an individual or firm intending to purchase an existing business

(*ii*) On behalf of an incoming partner

(*iii*) On behalf of a person intending to invest in a company

(*iv*) On behalf of a bank for purposes of credit

(*v*) On behalf of the proprietors of a business where a fraud is suspected

(*vi*) Under the Companies Act under Sections 235 and 237

(*vii*) Of profits on behalf of the promoters of a proposed company (for Prospectus purposes)

(*viii*) In connection with taxation liabilities.

(*ix*) To ascertain the amount of compensation in respect of loss arising through compulsory removal of business

Investigation on behalf of an individual or firm intending to purchase an existing business. When an investigation is to be

carried out on behalf of an individual or a firm having an intention to purchase an established concern, they will be more interested in knowing whether it will be worthwhile to purchase the concern or not The accountant called for the purpose may have to examine the following things in general

(a) earning capacity of the concern ,

(b) values of the assets ,

(c) extent of liabilities ,

(d) reasonability for the purchase price ,

(e) estimation of value of goodwill , and

(f) any other general points which may have bearing in this context

It is of prime importance to ascertain the earning capacity of the concern It is only on the basis of past achievement that its probable earning capacity in future may be ascertained The past achievements can be traced back with the help of the Profit and Loss Account of the past years Where the books of account have been properly kept and have been subjected to audit, the work of the investigator will be greatly facilitated However, he must examine the Profit and Loss Account very carefully He should set out the Profit and Loss Account of previous years in columnar form with a view to making comparison from year to year This comparison will be feasible if the Profit and Loss Account has been kept on a uniform basis The percentage of various items to the turnover should be calculated He should see whether there is any marked variation in the various percentages from year to year If it is so, he will have to pay special attention to the items in which there is a marked variation He should try to find out the cause of the marked variation and if no satisfactory explanations are available, he should probe deeper into the matter It will also reveal whether there is any abnormal expenditure incurred by the concern which brought about such marked variation

The true and net effective sales must also draw his attention He should prepare a statement of sales He should see whether there is any variation in the volume of sales If there is a marked variation he should enquire into the matter and find out the cause He should specially guard against the inflation of sales undertaken deliberately by inclusion of goods on sales or return of any fictitious sales He should find out whether the volume of sales has been influenced by the exceptional contracts entered into by the vendor or by his personal influence Such opportunities may not be available to the purchaser

Similarly, he should examine the item of stock-in-trade at the end of each period It may be subjected to greater manipulations. He should compare the stocks of past years and find out the variations, if any It should be fairly constant from year to year. He should check the stock at the end of the period with the stock records

and make enquiry whether the valuation of the stock has been carried on a uniform basis or not from year to year He should also examine the detailed stock sheets of past years very carefully to check any over-valuation of the stock For this purpose, he should test items with prices shown in original invoices He should then check the purchases It may happen that the purchases might have been omitted to inflate the profits of the concern He should make thorough examination of all the records to verify it He should check thoroughly the goods inwards book, bought ledger together with the purchase invoices and statement of creditors He should also check the various expenses It should be seen that all o/s expenses have been taken into account. He should make a comparison of expenses for a series of years to ensure that there is no omission of the expenses

It may be noted that the profits of a concern may be inflated by the following usual methods

(*a*) Inflation of closing stocks

(*b*) Inclusion of fictitious sales.

(*c*) Omission of purchases

(*d*) Including goods on sale or return or on consignment as completed sales

(*e*) Omitting wages, manufacturing and other expenses

(*f*) Taking capital income as revenue income, and capitalising the revenue expenditures

(*g*) Making less provision for depreciation or reserves etc.

The investigator should thoroughly enquire into the 'window dressing' of such type to inflate the profits and to show better position than what it actually is with a view to increase the sale value of the concern. He must guard against it and vouch the books of account very carefully. Thus the Trading and Profit and Loss Account should be subject to closer scrutiny with a view to ascertain the true amount of profit

But even if the net profits arrived at are taken to be correct, there is need for necessary adjustments in the amount of net profits Such adjustments have to be made with a view to ascertain the amount of profit which the intending purchaser will be able to earn in the changed circumstances, if any

The following items should be added to the profits of the vendors

(*i*) Interest on partner's capital and current accounts, if any The partner's salaries in excess of the fair amount of remuneration to the management should also be added

(*ii*) Interest on loans and overdrafts, if any If the purchaser has assumed certain loans, the interest on them need not be included It may also not be added if the liquid position of the concern is sound enough

(*iii*) Rents if the purchaser is purchasing the trade premises which was being utilised by the vendor who paid rents in the past

(*iv*) Discount on purchases, if any, and excessive cash discounts on sales

(*v*) Exceptional losses which do not arise in the ordinary course of the business, such as costs and damages in law suits, defalcations etc

(*vi*) Capital losses, *i e*, losses arisen on the sale of fixed assets.

(*vii*) Any additions or improvements of capital nature which might have been charged to the Profit and Loss Account

(*viii*) Provisions for bad and doubtful debts or other contingencies in excess of the usual normal provisions required

(*ix*) Excessive provisions for depreciation

(*x*) Any charges not incidental to the business, e g donations and subscriptions

The following items should be deducted from the profits of the vendors

(*i*) Income from those assets which have not been purchased by the purchaser

(*ii*) Rent, in case the purchaser has not acquired the premises used by the vendors and no charge had been made for the same in the Profit and Loss Account

(*iii*) Exceptional profits not arising in the usual course of business such as speculation profits or insurance profits etc

(*iv*) Capital profits arisen on account of the sale of fixed assets

(*v*) Depreciation to the extent it has not been adequately provided for.

(*vi*) An amount for the management's remuneration expected to be incurred by the purchaser But this should be deducted if the reasonable management remuneration has not been charged for in the Profit and Loss Accounts

(*vii*) Any known additional expenses which the purchaser will have to incur in earning the same gross income

Thus, there is need for proper adjustments in the amount of net profits of the concern to arrive at the estimated amount of the profits which the purchaser may earn after acquiring the concern

The annual Balance Sheet for some years should be tabulated and analysed The investigator should ascertain the value of the various assets shown in the Balance Sheet The object in view should be to find out the real worth of the assets to the purchaser when he will be utilising them later on But it is a difficult task to ascertain the correct value of the assets if they have not already been determined by the experts independently He should try to find out the

value of the assets as correctly as possible He may take the assistance from the experts, if necessary He should pay special attention to the adequacy of the amount of depreciation charged to fixed assets The difficulty that arises in this context is that the amount of depreciation which might have been adequate for the vendors may not be adequate for the purchaser in the changed circumstances unless the rates of depreciation are based upon the sale values, which is a difficult matter to ascertain He should trace out if there is any asset shown in the Balance Sheet which does not remain effective or is not in general use or may not likely to be of use to the purchaser He should prepare a Statement of Assets of past few years and make a comparison year-wise The difficulty may arise as to the assumption of the debtors He should compare and check it with the help of the statement of the debtors available to him He should also examine whether adequate provisions have been made for discounts and bad and doubtful debts It would be advisable that the purchaser should not take them over and should undertake to collect payment from them on behalf of the vendors

Similarly, he should prepare a statement of the liabilities of past few years and make a comparison year-wise He should see that there is no omission of the liabilities, specially the outstanding liabilities Due attention should be paid to those contingent liabilities which may be expected to become real ones With regard to the creditors also the difficulty arises Usually the purchasers do not assume the creditors and make payment to the vendors for the same or assume to pay them on behalf of the vendors It is a right approach also

Another important matter which requires special attention of the investigator is the amount of the goodwill demanded by the vendors If the amount of the goodwill has already been agreed upon, he will not have to worry about it The asscertainment of the precise value of the goodwill of the concern is really a difficult matter It is because it is an intangible asset and there is difference of opinion amongst the accountants as to the methods adopted for the purpose These methods have been discussed in the chapter "Valuation of Assets"

Besides, he will also have to consider the following general points in this connection

(i) The reason for the proposed sale by the vendor of the concern If it is because there has been keen competition in the line, it would not be advisable to purchase such concern specially if the competition has resulted in poor turnover On the other hand, if the vendor is disposing it off on account of the ill-health or old age and wants to lead a retired life, it would not be risky at all

(ii) He should evaluate the impact of the personality of the vendor upon the business of the concern If the nature of the business is such where the personality of the vendor counts more, the purchaser may be put to loss if he purchases such concern as he might not be having those qualities Similarly if the concern may

require special type of skill or influence which the purchaser may not possess, it would not be advisable for him to invest money in such concern

(iii) He should study the future demand of the commodity in which the concern deals If the concern deals with the fancy goods whose demand may fall to a considerable extent in the future with the change in the style and taste of the public, he should take special note of this On the other hand, if the concern deals with the manufacturing of certain commodity he should enquire into the efficiency of the plant and machinery in use and the effective future demand of the commodity produced He should also ascertain whether the bulk of sales are made to a small number of customers who may have friendship with the vendor and find out any possibility of withdrawal of their support

(iv) He should study the terms of contracts with the employees of the concern He should also find out if the contracts will continue in future also with the purchaser If they do not, will it effect the business considerably or have no effect at all ? The age of the present managerial staff should be examined He should find out any possibility for pension or gratuities of old and aged employees

(v) A very important point to be considered is to ascertain that the vendor will not be carrying on similar business at least in certain specified areas and upto certain period Even if the vendor continues the business on the same lines, he should be restricted from soliciting the old customers with whom he used to deal It would be better if the vendor does not continue the business on the same line at all

(vi) Reasonability of the purchase price agreed and the value of goodwill estimated should be carefully considered, keeping in view the future earning capacity of the concern

(vii) The burden of the contracts or other commitments undertaken by the concern should also be carefully weighed It should be see whether such commitments put undue burdens in the years to come If such commitments are expected to be profitable to the concern in the future it need not be a cause for worry

(viii) He should try to ascertain the period and the terms on which the business premises have been taken by the vendors It will be necessary only when the purchaser wishes to retain the business premises used by the vendors If the premises have been taken on lease, he should enquire whether its period shall expire shortly If so he should find out whether there will be any difficulty in renewal of the lease on reasonable and fair rents

2 *Investigation on behalf of incoming partner* The investigator will have to take those steps taken in connection with the investigation on behalf of the intending purchaser as mentioned earlier Besides, he will have to see other points also in this connection He will have to examine the partnership deed with a view to ascertain whether the terms and conditions laid down in the deed will be reasonable from the point of the incoming partner It may be men-

tioned that the object in view for such investigation is to find out whether it will be profitable or not to the client in joining the firm He needs all the information in this connection which may be of use to him in arriving at such a decision He should examine thoroughly the Profit and Loss Account of the firm of the past few years, say three years, and scrutinise in the manner laid down earlier He should, however, vouch very carefully the purchases, sales, stocks and various direct and indirect expenses of the firm The various percentages of the different items to the turnover should be calculated for past several years and should be closely studied to find out any variation Under variations should be enquired into

He should then examine the Balance Sheet of the firm Special attention should be paid to the valuation of the various assets shown in the Balance Sheet If the assets are overvalued and there is omission of the various liabilities of the firm it may result into overvaluation of the capital of the existing partners and it will have adverse effects on incoming partner, specially in the event of the dissolution of the firm Hence, the investigator should see that correct values have been placed against the assets and there is no omission of the liabilities He should see that adequate provision has been made for bad debts which may accrue to the firm in the coming years If it is not so, he should see that the continuing partners undertake to assume the responsibilities in this connection

He should also enquire into the reasonability of the amount of goodwill which the incoming partner has been called upon to pay He should see that the estimation of the goodwill has been made on the recognised and accepted basis and the past earning and future prospects have been taken into account

He should also see the proposed ratio of profits to be given to the incoming partner It should be seen that the adequate returns will be available to him on the investment which he has to make by way of contributing to the total capital of the firm

The reason why the continuing partners want to admit a new partner should also be ascertained and be made known to the client. In case the partner is proposed to be admitted because of financial weakness of the firm, it will not be profitable to invest capital in such firm The capital, if invested, will be utilised for the purpose of paying off creditors and other liabilities and may not be profitably utilised in the firm for earning purposes The investigator should try to ascertain this fact very carefully

He should see that the tax liability of the continuing partners does not fall on the incoming partner in connection with the profits earned when he was not a partner He should enquire into the assessments of the partners and the firm to ascertain this

3 *Investigation on behalf of a Person intending to invest in a Company* The prospective investor in a company may have a desire to invest in the preference shares or the ordinary shares or the debentures of the company The investigator may be called upon to ascer-

tain the earning capacity of the company, the continuance of such earning in the future and the value of the shares in the company On the whole he will have to ascertain whether it will be profitable or not to make such investment

Preference Shares If the prospective investor wishes to invest in the preference shares of the company, the investigator will have to enquire the following points

(*i*) The terms and conditions with regard to the issue of preference shares by the company as laid down in the Articles of Association and the Memorandum of Association

(*ii*) The rate of dividend payable on the preference shares—whether there is a fixed rate or not and whether the rate fixed is reasonable or not He should ascertain whether the dividend is cumulative or non-cumulative The security offered to the preference shareholders should be carefully examined

(*iii*) Determine the price of the shares This should be determined on the basis of the current level of the interest prevailing in the capital market of the country

(*iv*) The risk factor may be involved in the investment in preference shares of the company He should also see whether there will be any difficulty in the marketing of such shares and whether the shares are listed in the recognised stock exchanges of the country or not

(*v*) Ascertain the terms of issue of such shares with regard to the period when it will be redeemed, if any If it will be redeemed, whether any premium will be paid or not

Ordinary Shares If the prospective investor proposes to invest and acquire a substantial number of ordinary shares of a company, the investigator will have to proceed on the following lines

(*i*) He should study the provisions of the Articles and Memorandum of Association of the company to find out the proportion of the ordinary shares to that of the preference shares and their respective rights, *i e* the rights of voting, rights of that preference shareholders with regard to refund of capital and with regard to the cumulation of dividends, or any other extra rights granted to them It should also be seen whether the company has the right to issue further preference shares in future and to what extent it will affect the position of the ordinary shareholders

(*ii*) He should determine the value of the ordinary shares of the company This value may be determined either on the basis of the net assets of the company or on the basis of the yield of the company Under the first method, the total amount of liabilities is deducted from the total value of the assets and then it is divided by the number of shares to get the desired result Under the second method, the amount of profit available to the ordinary shareholders should be obtained and the capitalised value of the ordinary shares at the rate of the average earning of other concerns of similar nature should be found out. This capitalised value should then be divided by the

number of the ordinary shares to get the value of the ordinary shares To take an example, if the amount of profit available to the ordinary shareholders is Rs 40,000 and the average earning of other concerns engaged in similar business is about 8%, the capitalised value of the ordinary shares at the rate of 8% would be $\frac{40,000 \times 100}{8}$ =Rs 5,00,000 If the total number of the ordinary shares is 50,000 the fair value of each ordinary share will be $\frac{5,00,000}{5,000}$ or Rs 10 only

(*iii*) The future trends of earnings of the company should also be ascertained For the purpose, he should examine the audited accounts of at least two previous years and project on the basis of the past results He should also see fluctuations, if any, in the earning of the company in the past and enquire its causes and whether the fluctuations are only temporary and will not recur again and again The nature of the commodity dealt with by the company should also be reviewed with a view to find out the stability of the company in future A comparative study of the percentage of turnover to gross profits of the company for past three to four years may also be made which may have bearings upon its future working

(*iv*) A comparative study may be made of the rates of dividends declared on the ordinary shares of the company and that of other companies engaged in similar business The quoted value of shares in the stock exchange, if they are listed, should also be reviewed and comparison may be made with that of the quoted value of the ordinary shares of other companies in similar lines

(*v*) He should examine the various proposals which may limit the rates of dividends on ordinary shares The proposals may be for setting aside a sum for the redemption of the debentures or other loans or for the preference shares The policy with regard to the provision of reserves etc, should also be reviewed very carefully The funds to be set aside out of the profits of the company to make a provision for working capital should also receive his attention

(*vi*) He should estimate the proportion of future profits which must be left in the business with a view to make available the necessary funds for the expansion of the business of the company

Debentures If the prospective investor has a desire to invest in the debentures of the company or to lend money to it, the investigator will have to proceed on the following lines

(*i*) He should examine the provisions of the Memorandum and Articles of Association to ascertain the borrowing powers of the company and its directors In case they do not contain any provision in this respect, he should see if a resolution has been passed by the company in its general meeting authorising the directors to issue the debentures of secured loans

(ii) The terms of the issue of debentures or the borrowing should be carefully ascertained and scrutinised He should see that the terms are favourable to the client Special attention will have to be paid to the rate of interest to be given on that It should be compared with the rate of interest prevailing in the market

(iii) The earning capacity of the company and its stability should be found out on the lines mentioned earlier in other cases It is necessary because a sound and stable earning of the company would mean security to the investor He should see that the company has got enough regular earning so as to be able to pay interest at the fixed rate from year to year In this respect he should also see whether the company had been paying interest to its lenders regularly

(iv) He should scrutinise the security offered to the lenders by the company If adequate security is not given, it would not be advisable to risk the money He should also see whether the security given is by way of fixed charge or floating charge Previous charge, if any, should also be found out

(v) Purpose of obtaining loans or issue of the debentures should be carefully sought out If it is being obtained with a view to expand the company business and there are chances of increased earnings, it would be fair to invest for such purposes If, however, it is obtained for a purpose which may not prove fruitful to the company, the general prospects of the company must be ascertained before making any investment in it

(vi) He should then find out the provisions made with regard to the payment of loans or the redemption of debentures In case the Sinking Fund is created for the purpose, it will amount to greater security with regard to the payment of the loans or the debentures If no provisions are to be made with regard to repayment of loans or debentures, the investor will have to think twice before making such investment.

4 *Investigation on behalf of a Bank for purposes of Credit* The customers of a bank usually ask it for a loan or overdraft, but the bank always grants such loans or overdraft when it feels secured To ascertain whether the borrower will be able to pay back the interest and the loan itself or not, it sometimes gets the accounts of the borrowers investigated This has to be done with a view to ascertain the general financial condition of the customers, the security offered to it, the reason for obtaining such loans, the utilisation of such loans and the liquidity of the loans The investigator will have to proceed as follows

(i) He should try to ascertain the cause for taking the loan by the customer of the bank He should find out whether this additional fund is required for productive purposes or otherwise, or the necessity of the additional fund arose because the concern is under mismanagement and excessive frauds have taken place in it or its funds have been locked in some speculative or unproductive purposes.

(*ii*) He should examine the Profit and Loss Account and the Balance Sheet of the concern very carefully In case it is not ready the investigator should prepare it carefully He should also compare it with the final accounts in the past He should pay special attention to the position of the sundry debtors and the bills receivable, investments, insurances and secured liabilities The earning capacity and the general financial soundness of the customer should be obtained on the lines mentioned earlier in this chapter He should prepare a statement with a view to find the net liabilities of the customers, specially in the event of dissolution of the concern He should then compare it with the net worth of the different assets of the concern Thus, the proportion of the fixed assets to fixed liabilities and that of the current assets to current liabilities should also be ascertained.

(*iii*) He should find out the nature of the security offered to the bank—whether necessary and sufficient security is being offered or not, whether security will be by way of fixed charge or floating charge He should also find out whether any previous charge exists, the nature and value of such charge and its effects upon the client's position In case of a company the position of mortgages may be found out with the help of the Register of Mortgages or from the office of the Registrar of Companies

(*iv*) The performances of the borrower in the past should also be found out with regard to payment of interest and the debts Its dealings with the creditors should also be obtained

(*v*) The nature of the business carried on by the borrower should also be found out with a view to ascertain its stability or otherwise If he deals with the business of speculative nature or trades in a commodity whose demand is fluctuating or may undergo a big change with the change in the habit and the style of the consumers, his earnings may not be stable

(*vi*) The character, integrity and the quality of the management of the concern should also be carefully examined An honest borrower will take pain to return the loans undertaken but if it is otherwise there may arise difficulty in this connection

(*vii*) He should also ascertain the details with regard to the contingent liabilities, if any, of the concern intending to borrow It may arise with regard to the bills discounted, the accommodation bills, the pending law suits, or guarantees given etc The extent to which these contingent liabilities may become actual will have effect upon the capacity to pay back the loans etc

5 *Investigation when fraud is Suspected.* Investigation in case of suspected frauds is conducted on behalf of the proprietors of the concern Such investigation requires greater amount of skill and care on the part of the investigator It is because the simple types of frauds may be discovered by the regular audit and it is only for the frauds of complex nature that there is necessity for investigation Until a reasonable care and skill is employed for the purpose it will

be impossible to unearth such suspected frauds The task is rather difficult if the fraud in the form of manipulation of accounts is committed by those who are at the helm of affairs of the concern The other types of frauds i e misappropriation of goods and cash, are of common types and they also require considerable amount of care on the part of the investigator

The investigator should make certain enquiries before he actually commences the examination of the books of account for the purpose of investigating the suspected fraud He should consult with his client the period or the date from which he should commence the investigation He should enquire about the nature of the frauds known to have take place He should then make an enquiry with regard to the system of internal check, if any, prevalent in the concern He should then try to ascertain the weaknesses of the system and note it carefully The direction in which the chances of fraud are greater should carefully be ascertained He should find out from his client if he suspects any particular individual for the frauds If it is so, he should carefully note down his duties and the extent of control he has over the books or cash etc He should find out the extent of control the cashier of the concern has over the books of account etc He should also try to make himself familiar with the general office routine and its organisation and the weaknesses, if any This will facilitate his task to a great extent

He should chalk out a plan for the conduct of investigation but while doing so he should keep in mind its limitations He cannot depend upon any standard method of investigation since the nature of frauds and the particular circumstances in which such frauds might have been committed vary to a very great extent Any particular method of carrying on such investigation cannot be laid down which may be useful in all the cases where frauds have to be detected

We lay down below the procedure which he may adopt, in general, with a view to investigate the suspected fraud in the form of misapporpriation of cash

(*i*) He should first examine the method of recording the transactions in the Cash Book and other subsidiary books He should enquire the system of internal check in use He should find out the extent of control the cashier has over different books of account of the concern He should also enquire into the duties of the employees related to the receipts and payments of the cash

(*ii*) He should cast and vouch the Cash Book very carefully In the absence of proper system of internal check in use he will have to check it in detail Opening and closing balances of cash in hand and cash at bank should also be obtained With regard to the opening and closing balance of cash at bank, he should obtain a certificate from the bank

(*iii*) The transactions with the bank should be checked with the help of the Bank Pass Book Pass Book should be compared with the Cash Book after reconciling the bank balance. Special atten-

tion should be paid to the dates when the receipts are banked He should ascertain that the receipts of each day are banked intact the same day

(*iv*) He should obtain original pay-in-slips from the bank, if possible, and compare them with the counter-foils of the pay-in-slip books It is necessary to check the 'teeming and lading' It is a common type of fraud resorted to by the employees It is carried on with a view to hide the misappropriation carried on earlier It is happens that if the cashier has misappropriated the receipts from debtor X, he will take the cash received subsequently from other debtors and place it to the credit of debtor X whose remittance was originally misappropriated and will go on doing likewise indefinitely to prevent the debtor's account appearing overdue To do this the cashier will divide certain remittances with a view to obtain exact amount necessary for his purpose And it is here that the original pay-in slips at the bank may be helpful If the original pay-in-slips at the bank at their counterfoils maintained at the concern do not tally, it may be because of this teeming and lading resorted to by the employee

(*v*) He should check the discounts appearing in the Cash Book and see that no misappropriation has taken place by recording more allowances for the discounts than what actually was allowed He should find out that all the discounts allowed are in order and within the prescribed rules of the concern

(*vi*) He should compare the counterfoil receipt with that of the records in the Cash Book Similarly, if rough Cash Book is maintained it should be compared with the fair Cash Book

(*vii*) He should pay special attention to the proceeds from cash sales and for this purpose he should check the copies of the cash memos maintained

(*viii*) All the cash payments made by the concern should be carefully vouched with the help of the supporting invoices or receipts from the payees If the payments have been made through cheques he should ascertain that the names of the payees agree in the cancelled cheques and the invoices In case some invoices or vouchers are missing he should obtain their duplicates and if they are not available he should note it carefully He should, however, see that there is no irregularity and forgery in the payments made and everything has been done in orderly fashion

(*ix*) He should ascertain the system of payment of wages and salaries and try to find out the loopholes, if any He should also check it with the help of those persons who have knowledge of full facts with regard to the employees and their salaries

(*x*) He should cast and vouch the Petty Cash Book very carefully He should see that the petty cashier has been advanced with only the required amount of money and nothing more and all the expenses incurred by him are duly supported by relevant vouchers. He should keep in mind that the opportunities for frauds exist in the direction of petty cash transactions

(*xi*) All the drawings by the partners should be confirmed by the partners themselves.

(*xii*) He should carefully examine all the transactions related with the bills, specially with regard to the bills receivable He should see that the proceeds of the bills receivable have been duly received and recorded and it can be ascertained with the help of the bills in hand Payments made with regard to the bills payable should also be carefully vouched There is a possibility of misappropriation of cash received on account of the bills and shown in the books as dishonoured It must be duly examined

(*xiii*) Cash received on account of the sales of fixed assets etc should also be carefully vouched with the help of relevant receipts and agent's statements available, if any

(*xiv*) He should examine the purchase and sales transactions also very carefully He should vouch it to ascertain that there is no omission of sales and no fictitious purchases have been included in the books of account For purchases, he should check the invoices with the Goods Inwards Book and the Gatekeeper's Book For sales, he should see the Order Book, Sales Book, and the Gatekeeper's Book Balances due by the customers may also be verified For this purpose, he should obtain the permission of the client and send a circular to the debtors stating the balances due to them as shown in the book and asking them to confirm the same directly to him

(*xv*) He should check the bad debts written off and find out its authority He should ascertain that only genuine bad debts have been written off He should find out the genuineness of the allowances granted and returns made to the customers. Any unusual discount or allowance given should be duly verified and enquired into.

(*xvi*) All the erasures and alterations of figures found in the books should be noted He should, however, make full notes of the irregularities traced out during the course of the investigation and in case of the slightest suspicion he should probe into the matter in detail until he is clear about the truth It should be noted that he should have a searching attitude He may act as detective in this case to meet the desired end

6 *Investigation under the Companies Act, 1956* For the investigation of the affairs of a joint stock company, the Companies Act, 1956 contains certain provisions The Central Government has been empowered to appoint inspectors for the purpose In the following 4 circumstances, it may appoint inspectors to investigate

(*a*) On application either of not less than two hundred members or members holding not less than one tenth of the total voting power therein, in case of a company having a share capital [Section 235 (a)]

(*b*) On the application of not less than one-fifth in number of the persons on the company's register of members, in the

case of a company not having a share capital [Section 235 (b)]

(c) On a report by the Registrar under Section 234 dealing with the power of Registrar to call for information or egplanation, in case of any other company [Section 235 (c)]

(d) If the opinion of the Central Government is that (i) the business of the company is being conducted fraudulently, or (ii) the company was formed with fraudulent of unlawful purposes, or (iii) the persons concerned in the formation of the company have been guilty of fraud, misfeasance or other misconduct, or (iv) full informations have not been given to the members of the company regarding its affairs (Section 237)

In the above circumstances the Central Government may or may not appoint inspectors for the purpose but it *must* do so in the following two cases

(a) The company requires it by special resolution, or

(b) The court passes an order for it [Section 237 (a)]

To investigate the affairs of the company, no firm, body corporate or association can be appointed as inspectors Only an individual can be appointed for it (Section 238)

The inspectors appointed by the Central Government for the purpose of investigation of the affairs of the company have also been given power to investigate the affairs of the related companies (Section 239) Related companies include the company's subsidiary or holding company or a subsidiary of its holding company, or a holding company of its subsidiary The inspectors can also investigate into the affairs of any person who is or has at any relevant time been the company's managing director or manager

The inspectors so appointed have been given wide powers to examine on oath all past and present officers and agents of the company and other specified persons (Section 240) The agents of the company include bankers, legal advisers and auditors If the inspector wishes to examine any other person whom he is not empowered to do so, he may apply to the Court who may order such persons to appear before him and be examined on oath

It is the duty of the officers and the agents of the companies or other persons to produce all books and documents in their possession and generally to assit in the investigation If any such officer or agent refuses to produce any book or document or to answer any question put to him, the inspector may certify his failure or refusal, whereupon the Court may enquire into the case The Court may make an order for production before the inspector of all such books or papers within a date to be specified in the order or require such person to answer any question which may be put to him by the inspector

The inspector, under Companies (Amendment) Act, 1965, may with the previous approval of the Central Government require any body corporate (other than specified earlier) to furnish such information to, or produce such books and papers before him, or any person authorised by him in this behalf as he may consider necessary if the furnishing of such information or the production of such books and papers is relevant or necessary for the purpose of his investigation

The inspectors have also been given power to seize the documents or the books etc. with the help of the relevant authorities, provided he has got reasons to believe that they will be mutilated, altered, falsified or secreted (Section 240-A)

The inspector must report to the Central Government on the conclusion of the investigation He should submit an interim report too, if so required (Section 241)

The Central Government must forward a copy of the report to the company and also to any body corporate A copy of the report must be furnished, on request, to the applicants for investigation where the inspection is on their request If the inspection is under Section 237, a copy of the report must be furnished to the Court The Central Government may also cause the report to be published.

On receipt of the inspector's report, the Central Government may take the following actions

(i) If it appears that any person has been guilty of an offence for which he is criminally liable, it may, after taking necessary legal advice, prosecute such persons for the offence

(ii) If it considers desirable, it may arrange to have the company or any related company wound up, or it may make application to the Court for an order under Section 379 or 398 of the Act

(iii) If it appears to the Central Government that it is in the public interest, it may bring proceeding in the name of the company for the recovery of the damages in respect of any fraud, misfeasance or misconduct in connection with the company's formation or management, or for the recovery of any property misapplied or wrongfully retained

The expenses of the investigation by an inspector appointed by the Central Government shall be incurred by it in the first instance, but the persons specified in Section 245 will have to reimburse the Central Government in respect of such expenses

Investigations of Ownership of Company The Central Government, if it finds that there is good reason to do so, may appoint one or more inspectors to investigate and report on the ownership of any company and other matters relating to the company The purpose would be to determine the true persons who control the company or materially influence its policies or are financially interested in it (Section 247)

If the Central Government feels that it is unnecessary to appoint an inspector for the purpose, it may require any person believed to be or to have been interested in the shares or debentures of a company or to have acted as agent in this connection to give information to it

The inspector so appointed has the power to investigate the ownership of the shares of the managing agency company, if any, the persons who control the managing agency company, and the persons who share the managing agency remuneration

Where it appears to the Central Government that in the course of his investigation, the inspector has any difficulty in finding out the relevant facts about any shares, issued or to be issued, it may impose following restrictions on those shares

(*a*) Any transfer of those shares shall be void

(*b*) Where those shares are to be issued, they shall not be issued

(*c*) No voting rights shall be exercised in respect of those shares

(*d*) No further shares shall be issued in right of those shares

(*e*) No payment shall be made on those shares, whether in respect of dividend, capital or otherwise (Section 250)

The expenses of any investigation of ownership of company shall be defrayed by the Central Government out of moneys provided by Parliament unless the Central Government directs that the expenses or any part thereof should be paid by the persons on whose application the investigation was ordered

Duties If an auditor or accountant is appointed to carry out the investigation under the provisions of the Companies Act, extent of the enquiry, its general object and the manner and subject of the report shall be defined by the instructions appointing him. Although he will have to follow the instructions given to him, he may have to carry on a very detailed examination of the books of account and other relevant records of the company in most of the cases

The purpose of such investigation is to determine whether there has been any legal breach of duty by any officer or the directors of the company It should be mentioned that the legal breach of duty need not be of a criminal nature He should also have to ascertain whether the company has been put to loss because of the negligence on the part of the directors etc

The investigator will have to pay particular attention to the verification of the existence of the various assets of the company shown in its Balance Sheet He will also see the nature of the liabilities of the company incurred by it Inquiries will have to be made with regard to the discovery of the manipulation of accounts which might have been carried on by the trusted officers of the company He will have to examine the various terms of contracts,

if any, entered into by the company with its directors or officers and agents with regard to the contracts entered into with those concerns in which these directors, officers or the agents may be interested directly or indirectly He will have to ascertain the loans advanced to the directors of the company Particular attention should be paid with regard to the interest charged thereon, security offered therefor and the disclosure of such loans in the Balance Sheet etc

With a view to fulfil his purpose, he will have to carry on interrogation of the directors, officers and agents of the company If need be, he should seek guidance or experts, whether legal or technical, as may be required in the course of his investigation If he feels necessary, he may also interrogate the officers or the directors of the related company for his purpose

In case his investigation involves the various subsidiaries of the company, his work will be greatly increased He will have to consider in detail the numerous inter-company transactions and transfers He will have to see the basis on which the profits and losses of different concerns have been computed A detailed checking of numerous transactions would be necessary

7 *Investigation of Profits on behalf of the Promoters of proposed company (for Prospectus purposes)* Sometimes the promoters of a company, which proposes to acquire an existing business, engage the accountant or auditors with a view to obtain a certificate of profits which will have to be embodied in the Prospectus of the company inviting the public subscription Under the Companies Act, 1956 when a Prospectus is issued by or on behalf of an existing company or on behalf of any person who is or has been engaged or interested in the formation of a company it must contain certain financial reports specified in Part II of Schedule II of the Act, [Section 56 (1)]

The provisions of Part II of Schedule II of the Act may be briefly summarised as follows The Prospectus issued must include a report by its auditor with regard to its profits and losses for each of the last five financial years, and its assets and liabilities at the date to which the accounts were last made up The rates of dividends paid on each class of shares during each of the last five years must also be given Where the company is a holding company, the auditor's reports must in addition show either the combined profits and losses of the subsidiaries or individual accounts for each subsidiary, in each case so far as they concern the group or there may be a combined group statement of profits and losses The group assets and liabilities must be shown either jointly or individually, and the method of dealing with the minority interest must be clearly stated

The object of such investigation for the purposes of the Prospectus is to arrive at the normal trading profits for a particular period The investigator however, will have to confine himself with regard to the presentation of facts only and he should not try to give his opinion about the future working of the company

Before he undertakes the job of such investigation, he will have to keep in mind the fact that he will not be responsible to his client alone but also to the public who will subscribe the shares in the company on the faith of the report set out by him in the prospectus In the event of subsequent liquidation of the company, he may be held legally liable, and this point must be noted by him

Before he actually proceeds with the investigation of the concern he should first see that he has received clear instructions from his clients with regard to the investigation and the period which has to be covered The Act requires that at least five years should be covered but usually the investigator is called upon to conduct his investigation for a longer period He should obtain the Trading and Profit and Loss Accounts and the Balance Sheets for the period under investigation He should also obtain the auditor's report, if any, of the past years He should then make himself familiar with the nature, working and the special features of the business

If he finds that the books of account of the concern had not been subjected to regular audit, he will have to examine the books of account exhaustively The detailed vouching may also have to be carried on He will have to do as much work as an auditor is required to do His work will be enhanced to a great extent if he finds that the accounts of the concern have not been balanced and the final accounts have not been periodically prepared Under such circumstances, he will have to carry on detailed checking and he will have to prepare the final accounts as well

The detailed procedure which he has to adopt to examine the Profit and Loss Account and the Balance Sheet has already been dealt with in detail earlier while discussing the investigation on behalf of an individual proposing to buy an existing business The main difference between the two is that in the present case the objecttive in view is a bit narrower He should make a number of adjustments in the recorded profits or losses, or assets or liabilities with a view to arrive at the figures to be included in his report He should pay special attention to the provisions of the Companies Act, 1956 under which it is essential that the basis of computing profits should be clearly disclosed, and any adjustments which in his opinion are necessary must either be made in computing profits and losses, or assets and liabilities, and disclosed, or a note must be given indicating the adjustments necessary in his opinion where adjustments have been actually made, or where they have been indicated without disclosure of the reasons for them a signed written statement must be given setting out the adjustments and the reasons for making them

However, he should examine the Trading and Profit and Loss Account very carefully comparing the various percentages calculated He should pay special attention to the purchases, sales, stock-in-trade and various expenses He should see the provisions made for bad and doubtful debts and for the depreciation of the fixed assets For

Prospectus purposes, the fixed assets are usually valued at their current price and under such circumstances he should scrutinise it carefully The Investigator, however, will have no responsibility in the matter of such valuation of the fixed assets Other items of the Balance Sheet also require close scrutiny since on the basis of the Balance Sheet the existing business will be purchased. He will have to examine the values of various assets in detail before satisfying himself about the correctness of the values assigned to various assets

He should draft his report with regard to the profits of the concern very carefully His certificate or the report should be clear and precise in its wording The period covered under the investigation should also be clearly mentioned Any ambiguity should be tactfully avoided He should set out the profits of each year during the entire period of investigation separately Average profits may be given but only as an additional information His report should contain statement of facts and figures only He should not try to give his opinion as to the future possibilities or the merits of business He is required to give facts and not the estimates Any fact which ought to have been given in his report should not be suppressed as he will be incurring great risks if he does so

8 *Investigation in Connection with Taxation Liability* Sometimes assessees do not submit a complete and accurate return of income for purposes of taxation and under such circumstances the taxation authorities may engage the services of a professional auditor or accountant to investigate into the matter and find out the correct income of the assessee Investigation may also be made under Section 147 of the Income Tax Act, 1961, under which the assessment has been reported It may be done on the following two conditions —

(*a*) If the Income-tax Officer has reason to believe that, by reason of the omission or failure on the part of an assessee to make a return under Section 139 for any assessment year to the Income-tax Officer or to disclose full and truly all material facts necessary for his assessment for that year, income chargeable to tax has escaped assessment for that year, or

(*b*) notwithstanding that there has been no omission or failure as mentioned in clause (a) on the part of the assessee, the Income tax Officer has in consequence of information in his possession reason to believe that income chargeable to tax has escaped assessment for any assessment year.

The object of such investigation is to ascertain the amount of suppressed income year by year so that the additional tax liability may be computed and the tax evasion may be prevented Such investigation in respect of the tax which would otherwise be out of date, may be described as a "back duty investigation".

The procedure adopted for the purpose will depend upon the fact whether the accounts of the assessee have been correctly and effi

ciently maintained or not maintained properly Where the books of account have been properly kept and the accounts are prepared and duly audited, the investigator will not have to take much pain, and the procedure adopted will resemble the ordinary investigation of the profits already discussed at length in this chapter However, he will have to pay particular attention to the following items

(i) omission of sales,

(ii) inflation of purchases,

(iii) overvaluation of the stock,

(iv) inflation of various expenses, and

(v) excessive provision for depreciation or reserves etc

According to the provisions of the Income tax Act, necessary adjustment in the profits shown by the books of account of the assessee will have to be made The assessable income will differ from that of the book profits for the reasons that the Act does not allow certain legitimate business expenses for tax purposes and, on the other hand, many business receipts do not fall within the ambit of assessable profits

To trace out the omission of any source of income, he will have to carry out exhaustive checking of the receipts and payments of cash He should prepare the statement of receipts and payments through cash in respect of the individual who may be subjected to investigation, and find out if there is any excess of expenditure over the cash received It will indicate that cash has been received from certain sources which have not been disclosed Such possibility may be confirmed by making a detailed enquiry

Similarly the pass book should be subject to close and detailed checking in relation to the receipts and payments and made through cheques as distinct from cash The personal statements of each individual subject to investigation should be carefully scrutinised He will have to trace the origin of all lodgments and destination of all payments recorded therein The private accounts of the partners or the directors etc as the case may be should be checked to trace the deposits made therein on account of the cheques drawn in their favour by the business concern He should check the cancelled cheques in case the cheques so drawn could not be traced in the private banking accounts of the individuals He should make enquiry to ascertain the existence of banking account in the names of the taxpayers or their nominees which have not been so far disclosed in the accounts With regard to the payments also he should make closer scrutiny with the help of the private banking accounts This has to be done with a view to ascertain the existence of the assets which have not been disclosed He should also try to find out the nature of the risk covered by all the insurance policies taken for which the premiums have been paid Thus a detailed enquiry with regard to the receipts and payments made through cash and cheques would

reveal the source of income not disclosed or the existence of assets purchased but not disclosed

In case the books of account have not been properly maintained by the assessee, the investigator will have to take pains to ascertain the income of the assessee He will have to prepare the accounts on the basis of the informations available or gathered from different sources The relevant sources of information may be the various statements available, *i e*, the bank statement, statements available from the debtors or the creditors or various vouchers like invoices, receipts etc He will have to utilise exhaustively any other information or data available to him from any source On the basis of the accounts so prepared, he should ascertain the gross profits of the assessee and the assessable amount of the profits

If necessary informations are not available but the amount of total purchases is known, he may estimate the gross profits of the assessee on the basis of the usual percentage of gross profits on the purchases normally obtainable in the usual trade In the absence of necessary data, he will have to make estimation of the profits of the assessee by preparation of statements of "net worth" at the beginning and the end of the period under investigation But preparation of such statements would entail an exhaustive enquiry about the assets and liabilities of the assessee He should obtain from the assessee a complete statement of his present assets, bank accounts (current and deposit), investments, jewellery, cash and notes and real property, with the dates of acquistion, bank pass books etc With the help of such informations, he should prepare a columnar statement showing the wealth of the individual made up yearly to the closing date of the financial period From such income obtained with the help of such statement, he will have to deduct the assessee's living expenses and legacies and other non-taxable item to arrive at the net annual income.

While drafting his report the investigator should clearly mention in it the limitations under which the investigation were carried out and the deficiencies of the data available, if any He should also mention the points in respect of which he could not get satisfactory explanations He should present all the facts which led him to arrive at the assessable income of the assessee The precise extent to which he would like to assume the responsibilities should also be mentioned in his report

9 *Investigation to ascertain compensation for loss arising through compulsory removal of business* The need for such investigation arises when a business concern is compulsorily removed due to acquisition of the property by a public body like Municipal Corporation, improvement trust, port trusts, railway, electricity companies etc Such compulsory closure of the business concern at one place and its removal to another place and its re-establishment results into loss to the proprietor of the concern who has got a right to claim compensation for such loss from the public bodies

In such case a professional accountant or an auditor may be engaged be either of the parties, *i e* the public bodies or the proprietor of the concern, to investigate and ascertain the quantum of loss thus arising and the consequent claim for compensation The estimation of the fair amount of compensation should be primary in the mind of the investigator but the difficulty which he may feel on this score is that both the parties will have their own axe to grind The public bodies which have to pay the compensation will like to underestimate the amount of compensation whereas the proprietor of the concern will like to inflate the amount of profits earned by him with a view to claim more by way of compensation

The investigator will have to examine the following points to arrive at the correct amount of compensation

(*i*) The actual amount of expenses incurred by the proprietor of the concern in removing the business to a new place should be ascertained For this purpose he must examine the various vouchers available in this connection

(*ii*) He should also find out the actual loss suffered by the concern on account of the compulsory sale of stock and fixtures etc To ascertain loss arising from the sale of stock, he should find out the value of the stock assigned to it before the removal of the business concern and the amount realised from the sale of such stock The difference between the value of the stock and its sale proceeds would give the loss on sale of the stock

Similarly, to find out the loss on sale of the fixtures, he should find out the book value of the fixtures, before they were sold out and the amount realised on their sale The difference between the two amounts would give the loss on the sale of fixtures

(*iii*) He should find out the loss, suffered by the concern on account of the forfeiture of the lease, if any For this purpose, he should add ten to fifteen percent to the existing book value of the lease

(*iv*) He should ascertain the loss of goodwill and the loss in the earning capacity of the concern which would arise because of shifting the concern from one locality to another. For this the investigator will have to ascertain the profits of the concern for last five years at least and take their average The amount of the claim for compensation on his account may be ascertained on the agreed basis which will be related to the average profits of the concern in last five years, or on the basis of the difference between the average of last five years and that of the estimated average of the next five years

The investigator will, thus, ascertain the losses on account of different reasons stated above and then add them up to arrive at the

total amount of claim for compensation to be paid by the public bodies to the proprietor of the concern.

The investigator should mention clearly in his report the amount of the loss arisen under different heads and the total amount of the loss to be claimed

QUESTIONS

1 What is investigation ? Distinguish it clearly from auditing.

2. What is investigation ? Explain the duties of an investigator

3 What special points would you keep in mind while understanding investigation on behalf of incoming partner?

4 You have been appointed investigator by your client, who intends to purchase an existing business How would you proceed ?

5. A bank has been approached by his customer for more credit of huge amount You have been asked by the bank to investigate his credit worthiness. How would you undertake investigation ?

6 In a business concern, the management suspects some fraud and you have been asked to investigate How would you proceed ?

7 Explain the provisions of Companies Act, 1956 regarding investigation of a company

8 You have been appointed investigator by the taxation authorities with a view to find out tax liability of an income-tax payer. How would you proceed ?

9. You are appointed investigator by the promoters of a company for the purposes of prospects How would you investigate ?

10 A client of yours intends to join a firm as a partner and requests you to undertake investigation for the purpose How would you undertake it ?

11 Distinguish between auditing and investigation and explain how would you investigate if called upon to find out reasons for fluctuation in profits of a concern

Legal Decisions

Leeds Estate Building & Investment Co v Shepherd[1] (1887)

This case deals with the negligence of auditor in due preformance of his duties This Leeds State Building & Investment Co was formed with a view to deal in loans and lending money on mortgage The Articles of Association of the company provided that the directors were to be paid remuneration in proportion to the dividend paid and no dividend was being papable except out of profits It was further provided that the auditor was to state whether in his opinion the Balance Sheet was a full and fair Balance Sheet, properly drawn, so as to exhibit true and correct view of affairs of the company The company did not earn any profit for the whole period in which it carried on its business except in one year The Balance Sheets were false and misleading and were prepared with a view to show profits and declare dividends

The company went into voluntray liquidation and an action was brought by the company against the directors, the manager, and the auditors to hold them liable in respect of certain sums paid out of capital for dividend and for the fees and bonuses of the directors and manager respectively

Decision It was held that the auditor was liable for negligence and was called upon to pay the damages to the company His plea for the ignorance of the provisions of the Articles of Association of the company was also turned out

Sterling J, in the course of the judgment, said "It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it is a true and accurate representation of the company's affairs It was no excuse that the auditor had not seen the Articles when he knew of their existence"

1. L.J. Notes 1817, p 130

Lee v. Neuchatel Co, Ltd.[1] (1889)

In this case, the company was formed to purchase mines and work them in Switzerland The Articles of the company contained provisions to the effect that the directors would not be bound to reserve moneys for the renewal or replacement of any lease or of the company's interest in any property or concession In practice, however, the company used to make provision for depreciation It wanted to distribute the profits to the preference shareholders without making provision for depreciation on the fixed assets, namely, mines

The action was brought by Mr Lee on behalf of himself and all other ordinary shareholders with a view to restrain the company from the payment of dividends to the preference shareholders without first charging depreciation on the assets of the company

Decision It was held that where the Articles of Association specifically stated that is was not necessary to provide for the depreciation of wasting assets, there was nothing in the Companies Act to compel the company to do so

In the course of the judgment Lindley, L. J said. " It has been very judiciously and properly left to the commercial world to settle how the accounts were to be kept The Acts do not say what expenses are to be charged to capital account and what to revenue account, such matters were left to the shareholders, they may or may not have a sinking fund or a deterioration fund the Articles of Association may or may not contain regulations on these matters, if they do, the regulations must be observed, if they do not, shareholders can do as they like so long as they do not misapply their capital In this case, one of the Articles provides that the directors shall not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession but if a company is formed to acquire or work property of wasting nature *e g*, a mine, quarry or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property over the cost of working it may be divided among the shareholders, and this is true, although some portion of the property itself is sold, in one sense the capital thereby is diminished If it is said that such a course involves payment of dividends out of capital, the answer is that the Act nowhere prohibits such a payment as is here supposed The proposition that it is *ultra vires* to pay dividends out of capital is very apt to mislead and must not be understood in such a way as to prohibit honest trading It is not true, as an abstract proposition, that no dividend can be properly declared out of moneys arising from the sale of property bought by capital But it is true that if working expenses exceed the current gains, profits cannot be divided, and that if in such a case capital is divided and paid away as dividend, the

1 Acc L R, p 26.

capital is misapplied, and the directors implicated in the misapplication may be compelled to make good the amount misapplied I know of no obligation imposed by law or statute to create a reserve fund out of revenue to recoup the wasting nature of capital Subject to any provision to the contrary contained in the Articles, I believe the disposition of the revenue is entirely in the hands and under the control of the company Provided there is by the company no infraction of the capital and nothing in the Articles to the contrary, the disposition of the revenue is a matter of internal arrangement I am unable to see in this that either capital or the product of capital has been dealt with in a way which is not authorised"

Balton v Natal Land and Colonisation Co, Ltd,[1] (1892)

In the year 1882, a bad debt amounting to £76,000 was incurred and it was written off to the Profit and Loss Account At the same time the company credited to the P/L Account the similar sum which represented the increase in the value of lands held by the company In the year 1885 a trading profit was made and the company proposed to declare the dividend out of that Action was brought against this to restrain the payment of dividend

The plaintiff put forward argument that the value of land was over-stated and that the difference between the true value of land and the book value should be written off against the available profits It was also argued by the plaintiff that as an increase in the value of the land was credited to the Profit and Loss Account in 1882, the decrease in its value should also be debited to the Profit and Loss Account in the year 1885

Decision It was held that even assuming that part of the capital had been lost in the past and had not been subsequently made good, that was not sufficient ground for restraining the payment of the dividend The judgment given in *Lee vs Neuchatel Asphalte Co Ltd*, was taken up by the court in this case also and it was remarked that "it was not correct in estimating the profit of a year, to take into account the increase or decrease in the value of the capital assets of the company" The court felt that "assuming that a part of the capital had in fact been lost and not subsequently made good no sufficient ground was thereby afforded for restraining the payment of dividend, that the fact of the company having written up the value of their land in 1882 and credited the increase to the profit of that year in the manner described, did not place them under any obligation to bring into account in every subsequent year the increase or decrease in the value of their lands".

Lubbock v The British Bank of South America[2] (1892)

The company which was carrying on banking business, had sold to another bank its goodwill and property in Brazil and

1 92 L T Rep, 109
2. Acct L R. 1892 p 56

made thereby a profit to the extent of about £2,05,000. The directors of the British Bank wanted to put this sum to the credit of the Profit and Loss Account and to pay dividend to the shareholders of the company

The case was instituted by the plaintiff on behalf of himself and the shareholders with a view to restrain them from distribution of this surplus in the form of dividend They took the plea that it would amount to payment of dividend out of capital

Decision If the Articles so permit, a profit made on the sale of a part of the undertaking of a company is available for payment as dividend

Justice Chetty held that it was clearly profit on capital and not part of the capital itself The reason stated for this was that this sum was the surplus ascertained after the liabilities and capital were placed on one side of the account and the assets on the other Under the Articles the directors were justified in carrying over this profit to the credit of the Profit and Loss Account In pursuance of the Articles they had called an ordinary meeting and had passed the requisite resolution He, therefore, held that the directors were justified in distributing such a profit by way of dividend

Verner v General & Commercial Investment Trust Ltd [1](1894)

The General & Commercial Investment Trust Ltd, had an issued capital of £600,000 and its objectives were to invest the capital in stock, shares and securities According to the Memorandum of Association of the company the objects were "to receive the dividends, income, profits, bonuses and advantages of every description from time to time payable or receivable in respect of the company's investment and to apply the same respectively according to the provisions of the Articles of Association in force for the time being" The provisions of the Articles were that "subject to the rights of members holding share capital issued upon special conditions, the receipts of the company from the dividends, income, profits, bonuses and advantages payable or receivable in respect of the company's investment shall be applicable as follows The trustees may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as a reserve fund to meet contingencies or for equalising dividends, or for any other purposes of the company, and may from time to time apply the whole or any part of such funds for any purpose of the company"

The whole of the capital together with the proceeds of the debentures amounting of £300,000 was invested in securities In a particular year the market value of the securities went down to the extent of about £240,000 and it was estimated that the deficiency of £75,000 would be a dead loss and was totally irrecoverable The investment to that extent was worthless That year, i e in 1894, the

1 1894 2 ch 239.

income from the investments exceeded the current expenditure by nearly £23,000 The company wanted to distribute this amount of profit in the form of dividend to the shareholders without making good the loss in the value of the securities

A suit was brought against the company and its directors restraining them from the distribution of $23,000 to the shareholders without providing for the depreciation of the securities

Decision It was held that, although this course might some times be imprudent, there was no law which prevented it in all cases and under all circumstances

We reproduce the part of the judgment given by Lindley L J and A L Smith L.J as follows "The broad question raised by this appeal is whether a limited company which has lost part of its capital, can lawfully declare or pay a dividend without first making good the capital which has been lost I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principales A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital assets up to a given value But in the absence of some special Article or contract there is no law to this effect, and in my opinion, for very good reasons It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends, so long as its capital sunk in creating the business, was not represented by assets which would, if sold, reproduce in money the capital sunk A dividend presupposes a profit in some shape, and to divide as dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eye of businessmen The same observation applies to the payment of dividends out of borrowed moneys Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it, will be a payment of a dividend out of capital Fixed capital may be sunk and lost, and yet the excesses of current receipts over current payments may be divided, but floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess in which case, to divide such excess without deducing the capital which forms part of it, will be contrary to law . "

Wimer v McNamara & Company Limited[1] (1895)

In this case the company was formed with the object of carrying

1 39 S J, 450

on business as general carriers of mails, parcels, goods etc The company had made considerable provisions by way of depreciation on the assets in the previous years but in the year 1894 it made a profit of £5,816 12s 6d before making any provision for depreciation in respect of the value of the leases, goodwill or plant The company proposed to distribute the above mentioned profit by way of dividend to the preference shareholders The ordinary shareholders brought an action to restrain the directors from making such payment of dividends They took the plea that until the loss of capital had been made good no dividends ought to be paid

Decision. A company can declare dividend out of the current profits, without making good depreciation of fixed assets.

Stirling, J observed in his judgment Clause 117 of the company's Articles of Association provides that 'no dividend shall be payable except out of the profits arising out of the business of the company' What are those profits ? Apart from the use of word 'profits' in clause 117, there is nothing in the Articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up Further, the Articles appears to contemplate 'profits' at the excess of receipts over all expenditure properly attributable to the year It is necessary, however, to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of 'fixed' capital or of 'floating' or 'circulating' capital, and on this point I am of opinion that it is to be treated as loss of 'fixed' capital It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago at a certain cost, could now be made at a much smaller cost Having regard to the remarks of Lindley, L.J , in *Lee v Neuchatel Asphalte Company,* I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for on injunction "

In re London and General Bank Ltd [1] (1895)

The London & General Bank had advanced large sums to the customers by way of loans and overdrafts on current accounts, but the security lodged for them was quite insufficient The interest on loans was duly brought into credit in the books but as a matter of fact the interests were never paid This resulted into heavy losses to the Bank and its consequent failure The auditor of the Bank was fully aware of the insufficiency of proper security and that adequate provisions were not made in respect of doubtful debts The auditor, however, had brought this fact to the notice of directors who refused to alter accounts In his report, he merely stated, "The value of the assets shown by the Balance Sheet is dependent upon realisation "

1. Acct L.R , 1895, p. 173

Decision It was held that the auditor was liable for misfeasance and was liable to refund, by way of damages, the amount of the dividend One more point was laid down in this case that the auditor is an officer of the company

In the course of his judgment, Lindley L J, said ' It is not part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do An auditor has nothing to do with the prudence or imprudence of making loans with or without security It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably , it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that But then comes the question How is he to ascertain such position ? The answer is By examining the books of the company But he does not discharge his duty by doing this without enquiry, and without taking any trouble to see that the books of the company themselves show the company's true position He must reasonable care to ascertain that they do Unless he does this, his duty will be worse than a farce Assuming the books to be so kept as to show the true position of the company, the auditor has to frame a balance-sheet showing the position according to the books, and to certify that the balance sheet presented is correct in that sense But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company An auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations He is not an insurer, he does not guarantee that the books do correctly show the true position of the company's affairs, he does not guarantee that his balance-sheet is accurate according to the books of the company If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say by the fraudulent concealment of a book from him His obligation is not so onerous as this

"Such I take to be the duty of the auditor , he must be honest —that is, he must not certify what he does not believe to be true and he must take reasonable care amd skill before he believes that what he certifies is true

"What is reasonable care in any particular case must depend upon the circumstances of that case Where there is nothing to excite suspicion, very little enquiry will be reasonable and quite sufficient and in practice, I believe, businessmen select a few cases haphazard, see that they are right, and assume that others like them are correct also When suspicion is aroused, more care is obviously necessary, but still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified

in acting on the opinion of an expert where special knowledge is required "

"A person whose duty is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more Information and means of information are by no means equivalent terms An auditor who gives shareholders means of information instead of information, in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held judicially, to have failed to discharge his duty

"In this case I have no hesitation in saying that Mr Theobald did fail to discharge his duty to the shareholders, in certifying and laying before them the balance sheet of February, 1892 without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words, 'The value of the assets as shown in the balance-sheet is dependent upon realisation ' It is a mere truism to say that the value of loans and securities depends upon their realisation We are told that a statement to that effect is unusual that the mere presence of those words is enough to excite suspicion But, as already stated, the duty of an auditor is to convey information, not to arouse enquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it "

In re Kingston Cotton Mill Co., Limited[1] (1896)

The manager of the company had inflated its profits by deliberate manipulation of the quantities and values of the stock-in-trade This fictitious increase in the profits of the company resulted into the payment of dividends out of capital

The company went into liquidation and its auditor was sued for negligence in having relied upon the stock sheets prepared by the officer of the company and accepting the certificate of the manager as to the correctness of the stock-in trade without checking the stock in details It is to be mentioned that the item of stock in trade was shown in the balance-sheet with the note, "As per the Manager's certificate "

Decision It was held that it was no part of the auditor's duty to take stock of the company unless there is some suspicion He could not be regarded guilty for negligence by having accepted the certificate with regard to the stock-in-trade of a responsible officer of the company.

Extracts from the judgments given by Lopes L J, are given on the next page

1 Acct. L R. 1896, p 77.

"It is no part of the auditor's duty to take stock No one contends that it is He must rely on other people for details of the stock in-trade in hand "

" It is the duty of an auditor to bring to bear on the work he has to perform the skill, care and caution which a reasonably competent, careful and cautious auditor would use What is reasonable skill, care and caution must depend on the particular circumstances of each case An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong He is a watch-dog, but not a bloodhound He is justified in believing tried servants of the company in whom confidence is placed by the company He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably astutous and careful The duties of auditors must not be rendered too onerous Their work is responsible and laborious, and the remuneration moderate I should be sorry to see the liability of auditors extended any further than *In re The London & General Bank* indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the balance-sheet certified by the auditors and presented to the shareholders This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors It would be difficult to say this was not a breach of duty Auditors must not be made liable for tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors So to hold would make the position of an auditor intolerable "

Irish Woolen Co , Ltd v Tyson and others[1] (1900)

In this case the employees of the company committed frauds It was done through overvaluation of the stock and book debts and by an understatement of liabilities The invoices had been suppressed at the date of the Balance Sheet which reduced the amount of purchases and the amount of the creditors These invoices were entered in the subsequent period Fictitious profits were shown which amounted to £ 4,095

The auditor had done little work of audit for himself and most of the work was performed by his assistants

Decision. It was held that the auditor would have discovered the understatement of the liabilities had he taken care to call for the statement from the creditors and checked it accordingly with the Ledger Accounts Hence he was held liable for the damages on account of this With regard to taking of stock of the company, it

1. Acct , L R , 1900, p. 13.

was held that it was not a part of the duty of the auditor to take stock as was held in *Kingston Cotton Mills case* With due regard to the facts of the case he was not held liable for the insufficiency of provision for Bad Debts and the omission of provision for Cash Discounts and hence not held liable for damages on account of this

A part of the judgment is reproduced here "Mr Kevans (auditor) seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it, the investigation of the books he deputed to his assistants and it must be on the faith of their representations that he certified the balance-sheet I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself The auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy He is not an insurer against fraud or error, and if fraud is alleged, it must be shown with precision the acts of negligence for which he is said to be responsible There was certainly no duty cast on the auditor to take stock What he did was to have the calculations checked in his office, and this was done with proper care As to the provision for 'bad debts', if there is any one thing upon which an auditor is independent upon the officer, it is the writing off, or the making of, a prospective allowance for bad debts He has no personal knowledge of the customers, and Mr Kevans seems to have taken particular attention in reference to this There is no doubt that both the suppression and carrying over of invoices would have been detected if the auditor had called for the creditors' statements of account upon which payment was ordered, and compared them with the ledger I should have thought this was part of the auditor's duty for many reasons, but apart altogether from the statements of account and the monthly check, I do not understand how the carrying over of the invoices could have escaped detection by the accountant, who should have used due care and skill, and who was not a mere machine The invoices carried over were ultimately posted to the ledger. If they were posted to their true dates, it would be at once apparent tha they were not entered in at the proper time If they were postec under false dates, why was this not detected when the ledger account were checked with the invoices ? And when no invoices came int the books, it is admitted that this ought to have excited suspicion For these reasons I am of opinion that if due care and skill had bee exercised the carrying over and the suppression of invoices woul have been discovered, and the auditor is liable for any damage th company has sustained from the understatement of liabilities in th balance sheet due to this cause since 4th January 1892 I conside that not only are Mr Kevans and his assistants not free from blam for this, but also for the mechanical way the audit was carried out The measure of duty is the bringing of reasonable care and skill t the performance of the business directed to be done having regar first to the contract of employment, then to the character of th business itself, to the remuneration of the defendant and to all th other circumstances of the case In strict rule, however, the measu

of the duty is to be ascertained by applying to all the circumstances of the case the best consideration, so as to ascertain what ought to have been done under the circumstances"

In re Dumbell's Banking Co Ltd (1900)

In this case, the directors and the auditors were prosecuted under Section 221 of the Manx Criminal Code of 1872 which is similar to Section 628 of the Indian Companies Act, 1956 The allegations were that the auditors had joined in the issue of false balance sheets, knowing them to be false in material particulars and with intent to deceive and defraud the shareholders of the company. On the basis of the facts proved it was quite clear that the accounts were not only false but materially false The correspondence between the auditors and the managers proved that the auditors thought that the overdrafts were bad although it was taken to be good in the accounts They had also told the managers that they held strong views as to the overdrafts, but did not state those views in their certificate to the shareholders All the defendants including the auditors were found guilty and were sentenced to various terms of imprisonment

Re Joseph Hargreaves Ltd [1] (1900)

The company had appointed the auditor properly, but the auditor never signed its Balance Sheet as he found it to be incorrect The company paid the dividends which was persistently opposed by the auditor No resolution of the directors or the company was ever passed for the payment of such dividends The General Meeting of the company was also never convened Because of all this the auditor could not bring the fact to the knowledge of the shareholders. The things went on for several years like this

The Liquidator of the company brought an action for misfesance against the auditor and the directors of the company It was argued by him that the auditor should have brought the fact to the notice of the shareholders or should have resigned

Decision It was held that an auditor who refuses to certify the accounts of a company due to their incorrectness cannot be held liable it no general meeting was called by the directors and no accounts were submitted to the shareholders of the company

This is a peculiar case and part of the judgment given by Cozens-Hardy, J, may be given for reference as follows "He (auditor) could not, and would not, certify the correctness of this Balance Sheet, and I think he was perfectly right in refusing to do so He did not report upon it to the general meeting for the best possible reason—that there was no general meeting to which he could report, and it is sought really, it think, when one gets to the

1 Leeds Mercury, 16th February, 1900

bottom of the case, to render the auditor liable because he did not require a general meeting of the shareholders to be summoned, to which he could make a statement as to the improper conduct of the directors Well, how could he have summoned a meeting? He had no more power to summon a meeting than I have It would be startling, I think, to say that an auditor who knows he does not commence an action on behalf of himself and all the other shareholders, I suppose, against the directors who have improperly paid these dividends, or does not do that which he really had no power to do—get the general meeting together and inform them of the facts I think the duties of an auditor are accurately, and I might almost say, exhaustively defined by Lord Justice Lindley in the London and General Bank case, he must be honest, he must not certify what he does not believe to be true, he must take reasonable care and skill before he believes that which he certifies is true I think Mr Jones (auditor) has fully come up to that definition Certainly as far as I am concerned I am not prepared to extend the liabilities and responsibilities of auditors to the enormous extent to which I should be obliged to extend them if I agreed with the present application"

Foster v The New Trinidad Lake Asphalte Company Ltd[1] (1901)

During the formation of the company a debt amounting to 100,000 dollars was also taken over, since it took over the assets of another company This debt was considered irrecoverable at that time It was, therefore, not recorded in the books But subsequently it was paid in full together with the interest accrued realising £26,258 10s The directors proposed to distribute by way of dividend without any consideration of losses on other assets The debenture-holders brought an action restraining them from doing so.

The directors took the plea that since it was not recorded in the books and no value was placed on the asset in the books of the company, any subsequent income in respect of the same may be taken as a capital profit and it could be distributed as dividend to the shareholders

Decision An appreciation in the value of a book debt taken over by a company at the time of its formation, when realised, cannot be treated as a profit available for dividend, unless such surplus remains after a revaluation of the whole of the assets

Justice Byrne gave his judgment against the contention of the directors restraining the distribution and said, "It appears to me that the amount in question is *prima facie* capital and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected I must not, however, be understood as determining that this sum or a portion of it may not properly be brought into Profit and Loss Account or be taken into account in ascertaining the

1. Times, 29th November, 1901 and 1901 1ch. 208.

amount available for dividend That appears to me to depend upon the result of the whole account for the year It is clear, I think, that an appreciation in total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may in a proper case be treated as available for purposes of dividend This, I think, is involved in the decision in the case of *Lubbock v British Bank of South America* (1892 2Ch 198), cited with approval by Lord Lindley in *Verner v General and Commercial Investment Trust* (1894 2 Ch 239, at page 265), where he says moreover, when it is said and said truly, that dividends are not to be paid out of capital the word "capital" means the money subscribed pursuant to the Memorandum of Association, or what is represented by that money Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders, as was decided in *Lubbock v British Bank of South America*' If I rightly appreciate the true effect of the decisions, the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits, in proper cases, although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken "

Dovey & Others v. Cory[1] (1901)

This case is also known as the National Bank of Wales case In this case a charge of misfeasance was made against the directors of the company for paying the dividends out of capital The company did not make any proper provisions for the bad debts and dividends were paid in 1887, 1888, 1889 and 1890 which amounted £54,787 It was pleaded that if the provisions for the bad debts had been made and the bad debts written off, there would have been no profits available for dividends In the Court of Appeal Wright J held Mr Cory liable to the extent of about £55,000 But the case went as far as the House of Lords where the decision by the Court of Appeal was nullified

Decision It was held that the directors are not liable for improper payment of dividends if they acted bonafide and are entitled to rely on the officers of the company to prepare the true and honest accounts

"The House of Lords decided the case purely on the question as to whether the directors concerned was or was not justified in reposing confidence in the officials of the company, and did not feel themselves called upon to deal with the question as to whether the dividends had or had not in fact been paid out of capital "

Lord Chancellor (Lord Halsbury) as well as Davey, L J made it clear while giving the majority judgment that they could not accept

1. Times, 2nd August 1901 and 1901 A C 477

the decisions of the learned judges in *Lee v Neuchatel* and other cases They threw doubts upon the finality of the decisions, given therein He said, "I doubt very much whether such questions can ever be treated in the abstract at all The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question what may be treated as profits and what is capital Even the distinction between fixed and floating capital, which in an abstract treatise like Adam Smith's *Wealth of Nations* is appropriate enough, may with reference to a concrete case be quite inappropriate It is easy to lay down as an abstract proposition that you must pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero and possibly involve its ruin On the other hand, companies cannot at their will and without the precautions enforced by the statute reduce their capital, but what are profits and what is capital may be difficult and sometimes an almost impossible problem to solve When the time comes that these questions come before us in a concrete case we must deal with them, but until they do, I, for one, decline to express an opinion not called for by the particular facts before us, and I am all the more averse to doing so because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a court of law"

Davey, L J, held a different view and said "I desire to express my dissent from some propositions of law which were laid down in the Court of Appeal, and upon which your Lordships thought it right to hear the respondent's counsel The Learned Judges seem to have thought that a joint stock company, incorporated under the Companies Acts, may write off to capital, losses incurred in previous years, and may in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the Capital Account If this proposition be well founded it appears to me that a company whose capital is not represented by available assets need never trouble itself to reduce its capital, with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends out of current receipts My Lords, it may be that I have misapprehended the statement of law intended to be made by the Learned Judges in the Court of Appeal I think that is possible, because I find that in *Verner v General and Commercial Investment Trust* (1894, 2 Ch 124), 'perhaps', Lord Lindley says, 'the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and for part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law' I reserve my opinion as to the effect of an actual and ascertained loss of part

of the company's fixed capital But, subject to this observation, I think that the statement of law in the passage I have quoted is not open to objection, and it is only because the learned judge appears to me to have departed from it in his judgment in the present case that I have troubled your Lordships with these remarks"

Bond v Barrow Haematite Steel Co , Ltd [1] (1902)

The company incurred heavy losses in respect of mining leases, lands, buildings, etc It had required mines with a view to supply itself with iron ore but had to abandon them due to their being flooded out and the cost of pumping out the water turned out to be too heavy In the year 1900, the Profit and Loss Account of the company showed a debit balance of £ 157,605 12s 11d, before charging anything by way of depreciation of assets, which, when revalued, were found to give rise to heavy losses This profit was provisionally carried forward Some preference shareholders brought action against the company to compel it to pay their dividends out of the credit balance on Profit and Loss Account They argued that since there was no loss on the fixed capital that need not be made good.

Decision. It was held that the preference shareholders cannot claim dividends as a matter of right before making provision for reserves, which the directors thought necessary, provided the Articles give them power to put to reserve before the payment of dividend

London Oil Storage Co Limited v
Spear, Hasluck & Co [2] (1904)'

In this case Petty Cash in hand, as stated in the Balance Sheet, amounted to £ 796, but in fact the balance of Petty Cash in hand was only £30 The difference amounting to £766 had been actually misappropriated by the secretary, who maintained the Petty Cash Book.

The auditor's clerk simply compared the balance of the Petty Cash Book with the amount shown in the Balance Sheet and did not take care to verify its existence by actually counting the balance of cash in hand

An action was brought by the company for damages caused to it by the alleged negligence of the auditor It was argued that the auditor should have discovered the fraud had he simply taken care to verify the existence of the petty cash in hand

Decision It was held that the auditor had committed a breach of duty by not verifying the assets shown in the, Balance Sheet and was fined with a nominal amount of five guineas This nominal fine was imposed upon the auditor because it was considered by the jury that it were the directors who were guilty of gross negligence as

1 1902, 1 ch 353 and Times, 17th January, 1902.

2 Acct L K , XXXI, p 1

they allowed such a large balance of petty cash in the hands of the petty cashier

Alverstone, C J, summed up in his judgment as follows "The auditor most undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties, or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage The plaintiffs must satisfy you that the damage has been occasioned, to whatever extent you think it was occasioned, by the breach of duty on the part of the auditor The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by the man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans*, which contributed to, but would not be the cause of, the loss Was he guilty of breach of duty, and, if so, what loss was occasioned to this company by that breach of duty ? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company "

Re Crabtree Thomas *v* Crabtree[1] (1912)

In this case the trustees were authorised to carry on the business left by the testator and to give the profits arising therefrom to the testator's wife during her lifetime A depreciation was charged to the extent of 7.5% on the original cost of the machinery before the profit were arrived at The wife of the testator brought an action against this and took the plea that no depreciation should be provided on plant and machinery

The defendant argued that the object of the company was not confined only to the life of the original plant but to continue the trade indefinitely Therefore, when the asset got worn out and must be replaced in order that the company may carry out its object, it was necessary to make provision for the depreciation of such assets.

Decision It was held that in a manufacturing company where the capital equipment consists chiefly of plant and machinery and the company has to carry on business indefinitely, depreciation of machinery must be charged before the calculation of the divisible profits

We reproduce the part of the judgment below "But in the ordinary course of ascertaining the profits of a business where there is power machinery or trade machinery which is necessary in order to perform the work of the business, it is, in my opinion, essential that in addition to all sums actually expended in repairing the machinery, or in renewing parts, there should be also written of proper sum

1 1912, 106, L T 49.

for depreciation and that sum ought to be written off before you can arrive at the net profits of the business, or at the profits of the business, and it is not profit until a proper sum, varying with the class of machinery has been written off for depreciation

"The only authorities referred to were those of companies formed to work a wasting property, and in such a case all profits arising from the wasting property are divisible without any deduction for the depreciation in value of the wasting property That is because the object of the company was to acquire a wasting property and to divide all the profits That is not so here The profits of this business are not ascertained until a sufficient sum has been deducted to meet the depreciation of the machinery One of the witness in his affidavit referred to the 'saleable value' of this machinery That is not the right standard Here it is the value of the machinery for the purpose of this business, not the saleable value"

The Ammonia Soda Company, Ltd v Arthur Chamberlain and other[1] (1918)

In this case the company had discovered a new shaft of rock salt while it was boring the land for the supply of water to the company On account of this the directors appreciated the value of the land for the purpose of wiping off a debit balance in the Profit and Loss Account The company had incurred a loss of about £13,000 in 1910 In 1911, the value of land was increased from £63,246 to £83,788, thus increasing it by £20,542 This sum was utilised to cancel the debit balance of the Profit and Loss Account The company earned the profits to following years and from September 1912 to April 1915, dividends amounting to £15,669 were distributed amongst the preference shareholders It is to be noted that the facts were not concealed from the shareholders and the auditors also drew their attention through their report

The company brought action against the directors, Mr Chamberlain and Mr Cocking, holding them liable for the improper payment of dividends It was argued that the appreciation in the value of the land as done was not genuine at all The directors did it simply to write off the previous losses incurred by the company The loss in the past ought to have been wiped off out of the subsequent profits of the company which had been distributed by way of dividend to the preference shareholders It demanded the refund of the dividends paid by the directors

Decision. It is not necessarily illegal for a company to pay dividends out of the profits of the company during a current year without making good existing deficiencies in paid up capital or without making good a debit balance of Profit and Loss Account occasioned by losses in previous years.

It was also held that an increase in the value of fixed assets

1. 33 T L.R 509

arising out of a bonafide revaluation may be utilised by the company to wipe off the debit balance of Profit and Loss Account

We give below the part of the judgment given by Swinfen Eady L J, and Warrington, L J 'The plaintiffs contend that, although net profits were earned during the period, they were not available for dividend, and cannot really be considered 'profits' as in the earlier period of the company's history, a loss had been incurred, and they contend that until such loss has been first made good there cannot be any profits in the real true sense of the word In my judgment this argument is unsound and has been exposed again and again The Companies Acts do not impose any obligation upon a limited company nor does the law require it, that it shall not distribute as dividend the clear net profit of its trading unless its paid-up capital as intact, or until it has made good all losses incurred in previous years Counsel for the appellants invited the Court to lay down that wherever there was a debit to the Profit and Loss Account, irrespective of the way in which it arose, of the stage in the company's operations, and of the nature and business of the company, it was illegal to divide profits subsequently earned without first writing off out of those profits the amount of the debit To do so would be to fall into the error which Lord Macnagntem pointed out should be avoided, and would only serve to harass and embarrass businessmen, and impose upon companies a burden which Parliament has abstained from casting upon them The directors in this case were of opinion that no capital had been really lost, and they were of opinion that the value of the land and works as a going concern had been increased, as a result of their boring and exploratory work, to a considerably greater amount than £19,028 . The result of increasing the value at which the land stood was to give a credit which would have enabled the debit of £19,028 to be written off Part of it was, however, actually written off out of subsequent net profits Now, the debit consisted in part of a nominal depreciation in the fixed assets of the company, buildings, plant and machinery, and as regards the balance, it consisted of sums paid out of the subscribed capital of the company for mortgage and debenture interest, and directors' fees, there not being sufficient trading profits to provide these amounts The transaction was carried out with the full approval of the shareholders in general meeting, and in all honesty and good faith The dividends complained of, paid out of profits, and the defendants are, in my opinion, under no liability whatever to repay the same, or any part "

Warrington, L J, said 'There is, however, one accepted restriction on the powers of companies incorporated under the Companies Acts, namely, that they must not, under the guise of dividends or in any other way, return to their shareholders money subscribed for their shares, unless it be with the sanction of the Court under the appropriate statutory provisions It has been asserted to be a corollary of the rule I have just mentioned—which would make it illegal for a company to pay dividends out of the profits of a current

year, unless it first makes good deficiencies in paid-up capital occasioned by losses in previous years , or, to put the contention in a broader form, no dividends can properly be paid out of profits so long as there are losses previously incurred and not made good In my opinion, this alleged restriction has no foundation in law I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss, the nature of the business and the amount of the loss may be such that no honest and reasonable man of business would think of paying dividends without providing for it. In such a case, I apprehend the Court would take the view that a payment which no honest and reasonable man of business would think it right to make could not properly be made by directors "

Arthur E Green and Company v The Central Advance & Discount Corporation Ltd [1] (1920)

This case relates to the negligence of auditor for accepting the schedule of Bad Debts from a responsible official

The company was engaged in the business of money lending The plaintiff, the auditor of the company, had audited the books for many years He brought an action against the company for the payment of fees due to him But the defendants, the company brought forth the counteraction against the auditor for negligence and were ultimately awarded damages caused because of the negligence of the auditor

There were worthless debts amounting to about £19,000 with the company which were accumulated for a considerable period Some of the debts were quite old and some were even statute-barred It appeared that they were practically irrecoverable The auditor accepted the figures from the managing director and the board with regard to the writing off the bad and doubtfull debts every year He did not report to the shareholders about the inefficiency of the provision with regard to bad and doubtful debts and consequently the profits were inflated and the commissions available to the managers etc , were high enough He accepted the explanation given by the management that in money-lending business it did not matter how old the debts were, because people would come back and pay in order to be able to obtain further advances

Decision It was held that the auditor were negligent as they accepted a Schedule of bad debts furnished by a responsible official even though it was apparent that some of the debts were irrecoverable They also failed in their duty by not bringing this fact to the notice of the shareholders of the company

We reproduce below the relevant part of the judgment "The duty of the auditors was quite clear as to the statutory duties They had to make a report, and state whether in the opinion the Balance-

1. Acct L R LXIII, p 1.

sheet was properly drawn up so as to afford a true account, or statement of the company's affairs It was said by the company, and he acceded to the view, that they were not only to be honest, but were bound to exercise an extra ordinary skill but there was a standard The case for the auditor was that from time to time there was a bad debts meeting of the directors to consider a certain list which was prepared by the managing director and that they were entitled to rely upon the directors, that they had no reason to suspect Mr Foot (manager of the company) The auditors said that when the list of bad debts came back to them for them to settle the balance-sheet, Mr Foot had struck out some of the people they had put in respect of bad debts Mr Foot had been described as a man who would brook no interference, and I cannot help thinking that when the directors struck these names out of the list it was upon the instructions or advice of Mr Foot There was an Article which gave the company power, after 15 per cent had been earned, to declare a bonus to the managers, and for four years such a bonus had been voted by the directors in this way Obviously, it was to Mr Foot's advantage to show large balances in order that the director's discretion might be exercised by awarding such a bonus to Mr Foot himself

"This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors It would be difficult to say this was not a breach of duty"

This case deals with the important question of responsibility of an auditor with regard to acceptance of the provision of bad and doubtful debts by the managing directors of the company It has been made clear in this case that the auditor, if dissatisfied with the explanation of the managing director, should bring the fact before the Board and if nothing is done to his satisfaction, he must report the matter to the shareholders of the company

Farrow's Bank Ltd. (1921)

In this case, the company had written up assets considerably simply to make the profits available for the distribution of dividends In no case, a piece of property worth £5,500 was written up to £7,80,000 It should be mentioned then auditor was in the company's regular emp'oyment as its accountant and was convicted on various charges of conspiracy and fraud in connection with the published account of the bank, and sentenced to 12 month's imprisonment

In Re City Equitable Fire Insurance Co Ltd [1] (1924)

The City Equitable Fire Insurance Co carried on re insurance business Its chairman was also the senior partner in the firm of Ellis & Co , the company,s stockbrokers The Chairman had carried on extensive frauds against the company The Balance Sheet of the company for the years as on 28th February 1919, 1920 and 1921 did

1. Acct L R 1924, pp 53-68 and 81-102

not show the correct amount of the debts due to the company by its brokers and the manager The company went into voluntary liquidation and its Official Liquidator brought an action against the directors and the auditors of the company for misfeasance The charges against the auditors were under the following three heads

(1) In the Balance Sheet of the company the debts due by Ellis & Co, and Mensell (the company's general manager) were shown under the wrong heads of "Loans at call and short notice", or "Loans" or "Cash at Bank and in hand", and the auditor had failed to inform the shareholders this misdescription of the debts in the Balance Sheet

(2) The auditors failed to detect that much larger sums were in the hands of Ellis & Co, at the date of each of the Balance Sheets than were so included

(3) They also failed to detect and inform to the shareholders that a number of securities were in the custody of Ellis & Co who had pledged them to its customers

Decision The auditor were not held liable of any charge as it was found that they had acted with great care, skill and industry in the discharge of their duties

Mr Justice Romer was of the view that in general the auditors had no fallen short of their strict duty With regard to the first charge, he held that the sums owing by the Ellis & Co were shown under wrong heads but because of this no damages flowed to the company He considered that it would have made no difference to anyone, in the circumstances of the case, had the item been included under the headings of "Loans" or of "Sundry Debtors" It was no duty of the auditors to draw the attention of the shareholders to the fact that the directors were choosing to advance moneys to their stock-brokers or their General Manager Besides, owing to the sound position of the company at that time there were grounds upon which the auditors were entitled to assume that at the time of the audit these debts were not good

With regard to the second charge, it was held that even if on the examination of the subsequent events that took place, the transactions were of "window dressing" character, the auditors could not be held guilty of negligence in not detecting this from the books, having regard to the state of their knowledge at the date of each audit

As regards the third charge, it was held that the auditors had relied upon the certificate of Ellis & Co that the securities were in their possession, and the question as to whether they were justified in accepting these certificates instead of inspecting the securities personally was dealt with at some length, in the course of the judgment and is described below

Mr Justice Romar said · "That it is the duty of a company's auditor in general to satisfy himself that the securities of the company

in fact exist and are in safe custody cannot, I think, be gainsaid If authority for the proposition be required, it may be found in the passage from Lord Justice Lindley's judgment in the London & General Bank case, which has already been referred to The auditor in that case amongst other things, 'saw that the bills and securities entered in the books were held by the bank', and this the Lord Justice plainly treated as being part of an auditor's 'legal standard of duty', though he did not of course mean that in all cases the bills and securities should be lodged with the bank He meant 'with the bank or in other proper custody' Nor as it as all clear whether the Lord Justice meant that in all cases the securities should be personally inspected by the auditor For an auditor may 'see' that the bank holds the securities in the sense that he satisfies himself of the fact In the case of a responsible and reputable bank this, according to the evidance of Mr Van de Linde, would seem to be the custom of auditors But I think that it is a pity that there should be any such custom It would be an invidious task for an auditor to decide as to any particular bank whether its certificate should be accepted in lieu of personal inspection The custom, too, at once raises the question, much debated in the course of the evidence before me, whether the courtesy of accepting a certificate should be extend to an insurance company or a safe deposit company Indeed, if once it be admitted that, in lieu of inspecting the securities personally, the auditor may rely upon the certificate of the person in whose custody the securities have properly been placed the auditor would be justified in accepting the certificate of any official of the company who happened to be in charge of the safe in which the securities are placed, supposing such official to be a reputable and responsible person At some time or other it will, I think, have to be considered seriously whether it is not the duty of an auditor to make a personal inspection, in all cases where it is practicable for him to do, whatever may be the standing the character of the person or company in whose possession the securities happen to be I do not, however, propose to investigate this question further upon the present occasion For an auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in a custody of a person or company with whom it is not proper that they should be left Whenever such personal inspection is practicable, and whenever an auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter be put right at once, or, if this requirement be not complied with, to report the fact to the shareholders and this whether he can or cannot make a personal inspection The securities retained in the hands of Ellis & Co for periods long beyond the few hours in which securities just necessarily be from time to time in the possession of the company's stockbrokers, were not inproper custody The Ellis & Co were at all material times regarded, and reasonably regaded by Mr Lepine as a firm of the highest integity and financial standing is not to the point A company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be There are of course occasions when,

for short periods, securities must of necessity be left with the brokers, but the moment the necessity ceases the securities should be lodged in the company's strong room or with its bank, or placed in other proper and usual safe-keeping In my judgment, not only did Mr Lepine commit a breach of his duty in accepting, as he did from time to time, the certificate of Ellis & Co that they held large blocks of the company's securities, but he also committed a breach of a duty in not either insisting upon those securities being put in proper custody or in reporting the matter to the shareholders This was negligence, and but for Article 150 it would be my duty so to declare and to order Messrs Langton & Lepine to make compensation for all the damages that such negligence caused to the company, directing an inquiry to ascertain what those damages were For it is settled by authorities that are binding upon me that an auditor is an officer of the company within the meaning of Section 215 of the Companies (Consolidation) Act, 1908, though Mr Stuart Bevan, while admitting that it was not open to him to argue the contrary in this court, reserved to this clients the right to contest the point in a superior one But Article 150 in express terms includes the auditors of the company in the protection that it gives, and it must be taken to be one of the terms upon which the auditors were employed and gave their services They are therefore protected, unless the negligence of Mr Lepine in the matter was wilful This, it certainly was not, unless I am mistaken as to the true meaning of the phrase 'wilful negligence' I have heard Mr Lepine's evidence in the witness box, and I have inspected many of the numerous documents prepared by him for the purposes of the audits that he conducted I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company If in certain matters he fell short of his real duty, it was because in all good faith, he held mistaken belief as to what that duty was As against him and his partner, the application of the Official Receiver must accordingly be dismissed"

The master of the Rolls said "Now I come to the last point, part of which is contained in the third charge, and that is the failure to detect the fact that much larger sums were in the hands of Ellis & Co at the date of the balance-sheet, and the failure to detect and report that the securities were in the hands of Ellis & Co Now upon that matter I want to say a word or two about the evidence In fact Mr Lepine inquired from the bank and got a certificate from the bank that a certain number of securities were there, and then he turned to Ellis & Co and he got from Ellis & Co under the signature of Ellis & Co a certificate attached to the document, apparently not by Mr Bevan but by one of the partners a certificate that a number of securities were in the hands of stockbrokers It is said it was quite wrong to accept the certificate of the brokers, and we are asked to accept the evidence of Mr Cash and Mr Van de Linde as meaning this, that you may accept the certificate of a bank apparently in all cases, but you may never accept the certificate of stockbrokers I cannot agree that the evidence is so to be read, or is intended by the

witnesses to be so understood What I think the witnesses meant to express was this Banks in ordinary course do hold certificates of securities for their customers, it is part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then a bank is reputable bank, a bank which holds a high position, you may legtimately accept the certificate of that bank because it is a business institution in whose custody you would expect both to find and to put securities, and also it is respectable, but the fact that it call itself a bank does not seem to me to conclude the matter either one way or the other On the other hand, it may be said that it is the duty of an auditor not to take a certificate as to possession of securities unless from a person who is not only respectable—I should prefer to use the word 'trustworthy'—and also of that class of persons who in the ordinary course of their business do keep securities for their customers, and it may be said that a broker does not in the ordinary course of business keep securities for his customers, and therefore he is ruled out because the auditor ought not to accept from a person of that class, whether he be respectable or not, a certificate that he has got securities in his hands Now, accepting the rule as stated, that it is right to find the securities in the hands of the bank whose business it is to hold securities, and applying the proviso that the bank must be one that is trustworthy, it seems to me that that rule may be a right rule to follow and think it is prima facie, but it is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stockbroker, because it seems to me in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stockbrokers securities for the purpose of their dealing with them in the course of their business. With a large institution like the City Equitable Company, with a very considerable amount of investments to make and investments to sell, it may well be that for the purpose of the convenience of all parties it may have been useful method of business even if it had been examined with the most exiguous care, for the directors to decide that they would in the interest of their business leave securities of a considerable amount in the hands their stockbrokers, who I suppose, at that time held a position not less trustworthy or respected than the City Equitable itself I therefore do not wish in any way by anything that I say to discharge the auditors from their duties as laid down in the Kingston Cotton Mills case, far less do I wish to discharge them from their duty of seeing that securities are held and only accept the certificate that they are so held from a respectable, trustworthy and responsible person, be that person the bank or be it somebody else, but in applying my mind to the facts of this case I am not content to say that simply because a certificate was accepted otherwise from a bank therefore there was necessarily so grave a dereliction of duty as to make Messrs Langton & Lepine responsible I think in the light of the evidence which has been given it is for the auditor to use his discretion and his judgment, and his discrimination as to who he shall trust; indeed I think that is the right way to put a greater responsibility on the auditor

"If you merely discharge him by saying he accepted the certificate of a bank because it was a bank you might lighten his responsibility I think he must take a certificate from a person who is in the habit of dealing with and holding, securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment a trustworthy person to give such a certificate Therefore, I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but at the same time, I throw a burden upon him in respect of which the test of common sense can be applied and common business habits can be applied, rather than a rigid rule which is not based on any principle either of business or common sense"

In Re Union Bank of Allahabad (1925)

In this case the manager of the Bank had borrowed large sums of the company's money for his personal use and for his relatives without providing any proper security for the same He had sometimes invested the money in the worthless securities and to conceal the true facts from the shareholders he paid dividends out of the capital The auditor did not act carefully and accepted the vouchers He passed the accounts brought by the manager of the Baak He was indifferent and reckless in the conduct of the audit of the bank

Decision. It was held that the auditor was to refund the last two years' dividends in having signed the false Balance Sheet trusting a dishonest Manager and Secretary of the Bank Had he acted with reasonable care and skill he would have unearthed the real state of the company's affairs.

Part of the judgment given by Wallis, J, is reproduced here: "Unless auditors are to be held strictly to their legal liability, however honest they may be, the object of legislature in requiring certificate from them is absolutely defeated I hold that he (auditor) was utterly reckless and indifferent in his conduct as an auditor He was trusted to discharge his duty It is nothing to an auditor whether the business of a company is being conducted prudently or unprofitably It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that He is to ascertain that position by examining the book of the company But his first duty is to examine the books not merely for the purpose of satisfying himself that they show the true financial position of the company . In my opinion he allowed Kedar Nath (secretary) to throw dust in his eyes and to deceive him in the most obvious manner Me De (auditor) says that if he had examined the books and asked for an explanation about the Tata Industrial Bank's liability, he would have discovered in two minutes that the affairs of the Bank were in a very critical state and that the depositors and creditors were being defrauded He never asked a question and he signed a statement in the Balance Sheet saying that

he had received all the needed information and explanation These words are put in for the reason that an auditor is not mere airthmetical machine to check the figures in the books He should have satisfied himself not only that the accounts were correct, but that the books represented the true state of affairs of the bank"

L Hudson v. Official Liquidator, Dehradoon Mussoorie Electric Tramway Co , Ltd (1929)

In this case the management of the company had committed robberies Payments were made illegally The auditor did not exercise reasonable care and skill in performing his duties to the company He passed the dubious transactions and the illegal payments without any enquiry Even if he came across the transactions arousing his suspicions, he did not probe into the matter and did not demand any explanation for the same He did not examine the documents of the company very carefully.

Decision It was held that the auditor was guilty for misfeasance as he was reckless in the performance of his duties.

A part of the judgment is given below . "The objective 'wilful' in 'wilful acts and default' has evidently been used as a description and not as a definition The idea intended to be conveyed is that the default is occasioned by the exercise of volition or as result of the non exercise of will due to supine indifference, although the defaulter knew or was in a position to know that loss or harm was likely to result The word does not necessarily suggest the idea of moral turpitude The element of accident or inadvertence or honest error or judgment should be eliminated. The default must be the result of deliberation or intent or be the consequence of a rockless omission. Wilful default therefore, is indicative of some misconduct in the transaction of business or in the discharge of duty or omitting to do something whether deliberately or by reckless disregard of the fact and whether the act of omissions was or was not a breach of duty Under the Act where the auditors pass over illegal payments without demanding explanation and the facts disclose that there was deliberate abstention from performing plain and manifest acts and there was absolute duty cast upon them to enquire into the illegal payments and think over the real meaning of dubious transaction, they are guilty of misfeasance unless there is anything to the contrary in the Articles of Association"

Rex v. Kylsant and Morland[1] (1931)

The case is also known as *Royal Mail Steam Pocket Company case* In this case the auditor was charged with breach of duty in connection with the accounts of the company and was held liable for damages for the dividends which were paid out of capital It also deals with the vital question relating to the creation and utilisation of the secret reserves

The company had created excessive reserves in the name o

1 1931, Acct, p. 109 et seq

Taxation Reserves But for some years later on, the company had incurred actual trading losses, but the published accounts of the company showed profits out of which the dividends were paid The loss was converted into profit by utilisation of the taxation and other reserves created in past but which had not been disclosed in the accounts and were the secret reserves During 1921-1927, the company took to the credit of its Profits and Loss Account about £5,000,000 by drawing the secret reserves and non-recurring items as bonus shares received Nothing was shown in the accounts with regard to this except that the words "after adjustment of taxation reserves" were included in the item of income shown to the credit of the published Profit and Loss Account Thus the shareholders were kept in dark and were made to believe that the company was making considerable amount of profits

Criminal proceedings were taken against Mr Kylsant, the chairman of the company, with the charges that the chairman had issued false annual reports to the shareholders with the intention to deceive, and that the auditor had been guilty of aiding and abetting in the issue of such false reports Both the accused were acquitted of these charges ultimately

Mr Justice Wright remarked in connection with the auditor's position in regard to secret reserves as follows "If the accounts from which the dividends were being paid or the expenses were being fed by undisclosed reserves, it seems very difficult to see how an auditor could discharge his duty of giving a true and accurate view of the correct state of the company's affairs without drawing attention to those facts, which were vitally important

"No doubt an auditor in his important and delicate duties must use a certain amount of discretion, but whatever discretion he may feel justified in exercising, he must remember he is under statutory duty, and he may come under the penalties of law, if he fails in that duty

"The auditor is not concerned with questions of policy, but if he sees that there is something in the accounts to which he ought to draw the attention of the shareholders it is his duty to do so. Either he will not sign the certificate at all or he will sign it with some qualification such as circumstances require

"The question is not whether the two defendants or either of them have committed any breach of duty to the company, either as chairman or auditor If a breach of duty has been committed in connection with the accounts, if there has been any negligence, anything for which the directors or auditor may be liable to the company, then that is a matter directly and entirely beyond your purview and consideration.

"You are not here dealing with questions of civil liability For civil liability the appropriate remedy is an action for damages"

So far as the position of auditor with regard to the disclosure of the secret reserves to the shareholders is concerned it is a difficult and

delicate problem On the one hand, if the auditor discloses this the shareholders the very purpose of the creation of such reserves defeated and, on the other, if he does not disclose he may be failir in his duty towards the shareholders However, after the enactmei of the Companies Act in 1956 this problem does not exist for tl auditor because under this Act now no company in India can crea secret reserves with the exception of the banking, insurance and othe financial companies Therefore, for the companies, in general, tl secret reserves remain to be a matter of academic interests only

In Re The Westminster Road Construction and Engineering Co, Ltd [1] (1932)

In 1928, the company's accounts showed profits amounting t £3,458 whereas, in fact, it was only £297 The dividends were thi paid out of capital The profits shown in the accounts were th results of understating the company's liabilities and overstating th value of work-in-progress It may be mentioned here that the aud tor had also acted as accountant of the company in this case

An action was brought by the liquidator of the company again its directors and the auditors for the recovery of the dividends pai by the company It was alleged that they had failed in the proper di charge of their duties. The expert evidence with regard to the ove valuation of work in-progress was that is was the duty of the auditc to check the value at which work-in-progress was shown in th Balance Sheet

Decision It was held that the auditor was guilty of misfeasanc and was liable to refund the amount of dividend with interest thereo to the company

Part of the judgment given by Benett J, is as follows "If th auditor found that a company in the course of its business was incu ring liabilities of a particular kind, and that the creditors sent in the invoices after an interval and that liabilities of the kind in questio must have been incurred during the accountancy period under audi and that when he was making his audit a sufficient time had not ela sed for the invoices relating to such liabilities to have been receive and recorded in the company's books, it became his duty to mak specific enquiries as to the existence of such liabilities and also befor he signed a certificate as to the accuracy of the Balance Sheet, to g through the invoice files of the company in order to see that no in voices relating to liabilities had been omitted. The evidence ha established to my satisfaction that no experienced auditor would hav failed to ascertain the existence of the liabilities omitted from th Balance Sheet."

Armitage v Brewer and Knott[2] (1932)

The auditor was appointed to carry on the continuous an

1. 1932 Acct February, 1932, pp. 203-204
2. 77 Acct, L.R. 28; Accountant, 24 December, 1932 pp 836-40.

detailed audit A book-keeper, Miss Harwood, had embezzled a large sum of money by manipulating the wages sheets There was no system of internal check employed in the concern and Miss Harwood was in complete charge of the books, vouchers, wages sheets and other documents An action was brought against the auditor with the charge that he did not exercise reasonable care and skill in the performance of his duty

Decision It was held that the auditor acted negligently and he was ordered to pay the damages amounting to £1,259

Mr Justice Talbot said "The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of the wage sheets, check totals of wage sheets into wages book and check weekly totals with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter, they undertook a vigorous check, and they did so because that was what their client wanted He told them he wanted protection against petty frauds The defendants knew uncontrolled powers were committed to the person in the office Miss Harwood filled. They did not refuse the audit because of a risk of employing a woman in that kind of position What was required of them in the circumstances entailed more laborious work and more vigilance They undertook that work and the reassurances that Mr Armitage frequently asked for they gave That was a sufficient account of the duty they undertook. Had it been performed with the care they owed the plaintiff and which could be expected under their retainer from competent and upright professional people? His Lordship thought the answer to that was it had not However much it might be wrapped up, the defendants' case came to this, that systematic fraud for two and a half years by one person could not be detected by the exercise of a reasonable care on the part of the accountants It was doubtless true that to detect required minute examination of a large number of documents, but that was exactly what the defendants undertook to do

"As to the suggestion that some things were to trivial to notice and audits differed greatly as to scope and special instruction A 6s 1d had been altered to 16s 1d That was passed in what purported to be a meticulous examination The most casual inspection would detect the discrepancy on the voucher, both figures were there His Lordship was struck by the audacity with which many of these frauds were committed It looked as though Miss Harwood had found that she had nothing very formidable to fear in the way of audit. It was the duty of the auditor to bring that 10s – which was indicative not only of fraud but of forgery—at once to the notice of the principal That one piece of paper raised a grave suspicion It was of critical importance It was by little things like that, that forgeries and frauds were found out."

Official Liquidator, Karachi Bank, v The Director etc of Karachi Bank Ltd (1932)

In this case, the directors of the Bank had made a statement in the balance sheet that the profits earned by the Bank in 1927 amounted to Rs 15,608-14-9 But this amount of profits was arrived at by crediting to the Bank a sum of Rs 45,214 2-3, which was an amount held in suspense for bad and doubtful items of interest The official Liquidator of the Bank brought an action against the managing director, manager and the auditors for an offence under section 232 of the Indian Companies Act (now section 628 of the Act)

In the course of the judgment, Wild, J C said "What the Directors of the Bank have done is to show a cash profits for the year adding in a sum which is due no doubt but was never paid and was never likely to be paid The balance sheet, therefore, contains a false statement and a very material one and I am unable to see how it can be argued that it was not intended to mislead"

The Scarborough Harbour Commissioners v Thomas Whitehead and others[1] (1934)

The case deals with the negligence on the part of the auditors as they failed to report to the Board of Commissioners or to the Finance Committee about the arrears of rent and gas-money due to them from their tenants

In this case, Mr T Whitehead was the chairman of the plaintiff's board and also that of the finance committee He had control over the J Sellers & Co. Ltd, also The arrears of rents were due to J Sellers & Co Ltd which appeared in the Balance Sheet as good debts despite the fact that they were bad or at least doubtful to his knowledge The auditor was held guilty for negligence and breach of duty for not disclosing the truth to the Commissioners The auditors were, however, assured by some of the trusted officials of the company that with regard to the arrears due by the tenants the policy of the Board was not to press for the payment of the debts The auditors had believed that the financial condition of Mr Whitehead was sound and he had no grounds to assume that the debts were irrecoverable

Decision The Court of Appeal held that there was no dereliction of duty on the part of the auditor He was not guilty of negligence and breach of duty to the Commissioners in accepting the explanation given to him by the trusted and tried servants of the company.

It is to be mentioned that the auditor was not appointed under any statute in this case and his duties did not arise out of the statute but out of the contracts entered into

Master of Rolls said : "It is difficult to reconstruct the position as it stood before Mr Robinson What was his duty ? Was it to tell

1 1934, Acct, L R 65

the Commissioners what debts they ought to sue for, what debts they ought to forego ? It is for him to say when indulgence ought to be given and when stringency ought to be applied ? I do not think that is a right test to apply to an auditor We must take the circumstances broadly without any particular definition, and having regard to the circumstances that prevailed in this case I cannot say that the plaintiffs have established their charge of negligence against Mr Robinson "

Lord Justice Romer said, "It is impossible, I think, to lay down and general rule as to what is the duty of an auditor in all circumstances and in all conditions One must know by whom the auditor has been appointed, the circumstances in which he has been appointed, and the facts with which he has to deal, and it is then possible, to doubt, no say, as regards any particular circumstance, what the duty of the auditor was I mention that because this case has been presented to us as though Mr Robinson stood in the position of an auditor appointed by the shareholders of a limited company But I do not take the view at all. I do not think he was appointed in pursuance of any, statutory duty imposed upon the Commissioners to appoint an auditor He appears to me to be appointed by them purely for their own purposes It appears to me that an auditor, even an auditor in that position, has nothing to do with the policy of the board, that is to say, if the board choose to lend money to one person or another, it is not for the auditor to criticise their action by calling the attention of the shareholders pointedly to the fact that particular loan has been made In the circumstances I do not think it is necessary or that it was necessary for him to call attention specially to the fact, having regard to the inquiries he had made and the answers that he had received I agree further that an auditor would be guilty of a dereliction of duty, if, in preparing Balance Sheet for his employers, he includes as a good asset some thing that he knows is not, and if he could be shown that in this case Mr Robinson brought into the Balance Sheet as a good debt, this debt of Mr Whitehead's company, which was not in fact a good debt, I agree that the plaintiffs would have just cause of complaint against him In my opinion the plaintiffs have failed to show that Mr Robinson has been guilty of any breach of duty and, in my opinion, this action should be dismissed with costs "

Rex. v Hinds Musgrave and Steven (1940)

In this case the company, an engineering concern, had issued Prospectus for inviting applications for preference shares but the Prospectus contained misleading statements Prosecution action was taken against the two directors and auditors of the company The case was brought against them under section 12 (1) of the Prevention of Fraud (Investments) Act 1930 of England, which is quite similar to Section 68 of the Indian Companies Act, 1956

The charge made against the directors and the auditors were that they included the people to apply for shares in the company by

recklessly making misleading statements in the prospectus The auditor was prosecuted on the basis of report set out in the prospectus of the company It was in respect of a sum of £99,746 which was included in 'current assets' as 'expenditure in connection with development and expansion of export trade and newly formed subsidiary and associated companies—carried forward" It was found that this item together with the amount of profit of 1946, when the expenditure had already been incurred, was totally, misleading and the statement was recklessly made.

In the course of summing up Mr Justice Humphrise said "It seems to me a very serious matter for your consideration whether you can possibly, say that Mr Steven, having handed that matter over to his partner, and his partner having in fact made tests and satisfied himself at the time as an honourable man, as an accountant, and a careful accountant, that, that document was right, can you say that Mr Steven was reckless in accepting Mr Morton's (the partner's) explanation of the That is the one thing that is said to be against him There is plenty of evidence that in other parts he took meticulous care in trying to ascertain whether the books of this company were reliable or whether they were not But in this particular case his evidence is 'I relied upon Mr Morton'"

In Re G M Oka[1] (1952)

This case relates with the negligence in not verifying the securities before the issue of certificate for the same

In this case, the Assurant Controller of Insurance required from the Trinity Mutual Assurance Company Ltd a certificate duly certified by the auditor about the number of Government and approved securities held by the Company as on 31st December, 1949 Mr. G M Oka, the auditor, gave a certificate to that effect on 16th January, 1950 with regard to the point of the company as on 31st December, 1949

According to the certificate the face value of the securities held by the company was Rs 5,98,400, but the book value and the market value of the securities were quite different from this The book value of the securities was Rs 5,98,633 2-6 and the market value was Rs 58,915-4 0 much less than the book as well as the face value of securities. The company had not complied with the provisions of the Insurance Act, 1938, which required an assurance company to have ascertain minimum value of the Government and approved securities The company had already deposited Bombay Municipal debentures of the face value of Rs 1,00,000 with the Saraswat Bank as security against an overdraft These Debentures were not part of the securities included in the list of securities as they were encumbered with Saraswat Bank To company with the provisions of the Act, the management of the company had sold Conversion Loan 1946, on 13th January, 1950 and with the proceeds paid off the over-

1. C. A. No. of 1952

draft and redeemed the Bombay Municipal Debentures which had been pledged with the Saraswat Bank The Managing Director of the company had shown to the auditor the debentures and the auditors put the following remarks against this form of security "Purchased on 28th September, 1949 Lodged as security with bankers for overdraft, repaid in full on 13th January, 1949 Actual bonds seen " On account of all these circumstances and inclusion of the said Debentures as security, which was not correct, the certificate issued by the auditor of the company was false and misleading

The certificate issued by the auditor was sent to the Assistant Controller of Insurance who found it to be wrong and therefore made a complaint against the auditor to the Institute of Chartered Accountants of India The Council found the auditor guilty in the performance of his duties is not verifying the securities The case was taken to Bombay High Court The Court also found Mr Oka, the auditor, guilty

Following is the part of the judgment given by Chagla, C J. : "Now the only answer which the respondent (auditor) can give and has given through his counsel is that he was very credulous that he accepted the statement made by Mr Nadkarni that the overdraft has been repaid from the company's other funds, and acting on his statement he did not verify whether all the securities were there on the 16th January but merely saw the Municipal Bonds which had been released from the Saraswat Bank and issued the certificate The case of the respondent that he issued this certificate on a misrepresentation made to him by Mr Nadkarni rests solely on the word of the respondent It is very easy when you are charged with misconduct to throw the blame upon someone else who is not present to defend himself It is true that Mr Nadkarni is convicted out of his own mouth by his letter he had written to the Assistant Controller of Insurance on the 1 th January, 1950, but that letter does not show that Mr Nadkarni made a false statement to the respondent The other possibility has clearly to be taken into consideration, viz, that the letter was written and the certificate was sent in conjunction with and in consultation with the respondent But even assuming that we have to eliminate that possibility which would convict the respondent of colluding with Mr Nadkarni in deceiving the Assistant Controller of Insurance, the fact remains that as a responsible Chartered Accountant acting as an auditor of the Insurance Company, called upon to give a special certificate, he failed to verify the securities as on the 16th of January and issued a certificate, which admitted is an incorrect certificate We fail to understand how any auditor can seriously put forward in his defence that he was gullible, that he accepted someone's statement at its face value and failed to discharge his duty of verifying the securities The very defence and the very explanation renders the respondent unfit to continue as a member of the Institute of Chartered Accountants His certificate, his signature, his verification carry great weight, and they are usually accepted as correct and genuine. In this particular case the Assis-

tant Controller of Insurance accepted the certificate, did not prosecute the Insurance Company, and it was only when it was found out by the Assistant Controller that the certificate was not genuine and that he had been misled and deceived that he preferred a complaint to the Institute of Chartered Accountants In our opinion, this is a serious case and we agree with Sir Jamshedji Kanga, who is appearing on behalf of the Council and who asks us to take a serious view of the conduct of the respondent

"Under the circumstances, we think that the proper order we should pass is that the name of the respondent shall be temporarily removed from the Register of Chartered Accountants for a period of six months The respondent should pay the costs of the case "

Devar & Sons Ltd. *v* M.S Krishnaswami[1] (1952)

In this case the auditor was held guilty for misfeasance as he did not bring to the notice of the shareholders the fact that the sinking fund was not created as it was required by the debenture trust deed.

Debentures were issued by the Amalgamated Coffee Estate Ltd, Madras These Debentures were secured on the properties of the company by a Deed dated 8th January, 1945, executed by the company in favour of Mr B N Vishwanathan, the managing agent, as trustee of the debenture-holders The debentures were issued with a condition besides others that the company shall establish a special fund called sinking fund for the redemption of the debentures and shall each year provide a sum of Rs 33,000 out of the profits of the company or other resources

The company's published accounts showed the profits but the sinking fund was not created The Balance Sheet also did not show any sinking funds

The action was brought by Devar & Sons, who had purchased a number of the debentures The allegation was that inspite of the fact that the published accounts of the company showed profits during the financial year ending 30th April, 1945, it had been transferred anything to the contemplated sinking fund. Later on also the company made profits in 1946, 1947 and 1948, but sinking fund was not created at all Thus, the Balance Sheet did not show the true and correct state of affairs of the company and was misleading

The defendants, the auditors, pleaded that it was not their part of duty to see whether the company paid to its creditors or not, or whether the company set aside any sum for the redemption of debenture or not It was for the debentureholders to see that the terms of issue of the debentures were being duly carried out by the company

The auditors were held guilty by the Madras High Court A part of the judgment is reproduced below "We do not think it is

1 Referred Case No. 56 of 1951.

necessary to decide the question whether the directors of the company were not under an obligation to create a sinking fund, though we are inclined to take the view that the trust deed did contemplate such an obligation But we are clearly of the opinion that it was the duty of the respondent as an auditor to have mentioned the fact that in spite of the company earning the profits no part thereof had been set apart towards the sinking fund and that on the other hand the company had borrowed Rs 33,000 from the managing agents for the purpose of sinking fund investments A sinking fund primarily denotes 'moneys set aside for the purpose of sinking or wiping out a corporation's debt by degrees' Such a fund is created by periodically debiting instalments against profits and crediting the amount of such instalments to the sinking fund account

"Having regard to the nature of the sinking fund and its purpose, it strikes us extremely strange that the company instead of allocating the prescribed sum from and out of the profits should have borrowed that amount from the managing agents But surely it was incumbent on the auditor to have drawn the attention of the shareholders to this extraordinary action of the directors It is taken as an axiom in auditing that no sum which is not set aside out of profits can properly be called a reserve

"We, therefore, hold that the respondent failed in his duty as an auditor in not drawing the attention of the shareholders to the fact that the sinking fund was not created as contemplated by the debenture trust deed and in not making clear the fact that the amounts shown as towards the sinking fund were borrowed from the managing agents

"We agree with the finding of the committee that the respondent was guilty of gross negligence in accepting as correct during the course of his audit the Journal entries which were mere book entries and that he was guilty of passing the balance-sheets as on 30th April 1946, 30th April 1947, and 30th April 1948, which contain material defects and misleading entries as regards the sinking fund investments and the cash described as being with the debenture trustee or the managing agents We holds that the respondent must have known or with the exercise of due diligence could have known that no investments existed and there was no cash of Rs 33,000 with the managing agents as shown in the balance-sheet as on 30th April 1948 but nevertheless he certified to the correctness of the relative entries"

Commissioner of Income-tax, Madras[1] v G.M. Dandekar of Messrs. G M. Dandekar & Co., Madras[1] (1952)

Messrs G M Dandekar, the Chartered Accountants, were engaged by A. Mohamed & Co to audit the accounts of the firm The company used two keep to separate sets of books of account but the auditors were never told about this The Income Tax Officer was

1. Referred case No. 57 of 1951.

informed of the appointment of Messrs Dandekar & Co by the company The auditors examined the books of account of the company and signed a few statements including the Trading and Profit and Loss Account, Profit and Loss Adjustment Account, Balance Sheet But the quantitative statement of stock, purchases, sales and closing stock was signed by A Mohamed & Co

The action was brought by the Commissioner of Income Tax against the auditors with a charge that they were guilty of negligence in discharge of their duties The following allegations were made against them

(1) That their certificate that the books of account of A Mohamed & Co, for the year ended 29th October, 1943, were kept in the usual course of business was unwarranted,

(2) that they failed to report the omission of the cost which was debited in the main book and which was not accounted in sales or the closing stock, and

(3) that their subscribing to the unsubstantiated plea that some of the sales recorded in the separate book were from and out of the unaccounted purchases debited in the main book was misleading

The auditors pleaded that they were not engaged with a view to audit the books of account They took the examination of the books of account of the company with a view to present it to the Income Tax Officer and it was not a certificate but merely an opinion given about the books According to the terms of appointment they were not expected to go beyond the books of account

Decision The case was decided in favour of the auditors and they were not held guilty for negligence

Part of the judgment given by Venkatarama Ayyar, J, is given below " The point for decision is whether on the facts-mentioned the respondent can be held to be guilty of gross negligence There can be no negligence unless there is a duty cast upon the person to do a particular act and he fails to do it

"It is, therefore, necessary to ascertain what the duties of the auditors are as the auditor of Messrs A Mohamed and Co It is contended by the respondent that when an assessee engages him for auditing his accounts and preparing the income tax return for him, his duty is only to prepare the statements on the basis of the accounts produced by the assessee and that he is under no obligation to go further and enquire whether the account books maintained by the assessee are reliable

But the question is whether there is the same duty when the auditing relates to the accounts of individuals In those cases the auditor acts only for those individuals and it is his duty to act on their instructions, and to audit the accounts produced by them and prepare statements from them. He is under an obligation to them to perform the auditing with due skill and diligence and if he does

that, it is difficult to see what further obligation he has in the matter and in favour of whom In like manner the accountant is under a duty to prepare and present correct statements of the accounts of the assessee, and he should, of course, neither suggest nor assist in the preparation of false accounts But he is under no duty to investigate whether the accounts produced by the assessees are correct or not

" But if the duty of the respondent was only to prepare a correct statement from the accounts of the assessees and not to investigate where those accounts are correct or not, this charge must fall on the ground The respondent did not state that the figures mentioned in the statement represented the real profits made by the assessees He only stated that the balance sheet represented the correct position according to the accounts of the assessee.

"There is no charge against the respondent that he connived at the assessees' putting forward false statement or that he had in any manner associated himself with the attempt of the assessees to mislead the department The charge is that he owed a duty to the department, to himself investigate the truth and correctness of the accounts of the assessees and not merely to act as their post office in transmitting them We do not agree that the respondent is under any such duty to the department and, therefore, no question of negligence arises

"In the result we hold that the respondent is not guilty of any conduct which renders him unfit to be a member of the Institute."

The Registrar of Companies v P. M Hedge[1] (1954)

In this case the auditor was held guilty for gross negligence because he did not verify the existence of cash in hand and also because he did not inform the shareholders about the non-compliance of the provisions of the Companies Act, 1913

The Rural Bank of India Ltd had not complied with the provisions of the Companies Act, 1913 and the cash in hand disclosed in its Balance Sheet was also not correct The respondent had been appointed as an auditor of the company The auditor did not act with reasonable care and negligence and failed to discharge his duty to the shareholders The main charges against the auditor were with regard to the following

(*a*) He did not verify the cash in hand at the head office on the date of the balance sheet in each of the years, viz , 1945, 1946, 1947, 1948 and 1949, and

(*b*) he did not report to the shareholders that the company had not complied with the provisions of Section 101 (2-B) of the Indian Companies Act, 1913

The auditor pleaded that he had verified the existence of cash in hand but the verification was carried on the dates other than that

1 Chartered Accountant No 1-D of 1953

of the Balance Sheet He stated that he had checked the amount of cash in hand on 5th December, 1945 for the Balance Sheet as on 31st October, 1945 Likewise, he had verified the cash in hand each year However, he had not checked the cash in hand at the head office on the date of the Balance Sheet He did not care to check the balance of cash in hand at the dates of counting and that of the Balance Sheet

Decision In the course of the judgment Their Lordships quoted Lord Alverstone in the case of *London Oil Storage Co , Ltd* v *Seear Hasluck & Co* "it cannot be disputed that when an auditor returns to the shareholders an entry of cash in hand, he must have taken reasonable steps to ascertain that the cash was in hand" He continued "Cash in hand is verified either by production of actual cash balance or if the date of the accounts has gone by, by exhaustively vouching the cash count up to the date of audit and then counting the balance of cash in hand It is, of course, obvious that in the case of cash at distant branches a satisfactory certificate from responsible officers of the branches that the balance exists may generally be accepted in lieu of actual counting In our opinion, it is the duty of the auditor, except in special circumstances, to verify the cash in hand on the material date The respondent admittedly did not verify the cash no the materiay date, and even when at a later date he made a check he did not examine the intermediate transactions We, therefore, agree with the finding of the Council that the respondent, who was required to satisfy himself by actual verification that the cash did exist on the date of the Balance-Sheet and Profit and Loss Account exhibited a true and correct view of the Bank's affairs, had failed in his duty to satisfy that asset was there "

With regard to the second charge against the auditor. Their Lordships said "Even assuming that the managing director did give this explanation, it was the duty of the respondent to have mentioned that there was non-compliance with the statutory direction the very failure to deposit the moneys should have aroused his suspicion, and very probably a searching enquiry would have revealed the fact that the major allottees of the shares had not paid a pie for the large number of the shares allotted to them "

"We, therefore, agree with the Council of Institute of Chartered Accountants that the respondent failed to discharge his duty as an auditor of the Rural Bank of India Ltd and he was guilty of gross negligence ."

It may be mentioned here that the provisions of Section 10 (2-B) were that all money received from applicants for shares shoul be deposited in a scheduled bank until the company is allowed commence business or it is returned to the applicants for want minimum subscription before a particular date

Deputy Secretary to the Government of India, Ministry of Finance S N Das Gupta[1] (1955)

In this case, the auditor was held liable for not verifying the cash balance and for not giving informations to the members in unequivocal words He was found guilty of misconduct and suspended from the membership of Institute of Chartered Accountants and from practice for two years from the date of order

The respondent had acted as an auditor of the Aryan Bank for the years 1942, 1943 and 1944 The Bank went into liquidation later on The auditor had failed to verify the cash in hand for the years 1942 and 1943 For the years 1942 and 1943 the auditor simply gave a certificate in accordance with the provisions of Section 145 (2) of the Indian Company Act, 1913 and in it he simply answered the four specified question in affirmative He made certain reservations in special report but it turned out to be simply the means of information and not the information itself For example, he gave the following statements in his special report

"All the loans and overdrafts of branches are shown in the Balance Sheet as good "

"These have been granted to eight parties against the fixed deposit receipts of debtors "

These statements were found to be incomplete and vague by the Court and Disciplinary Committee The Committee stated that his duty was to give information and not merely the means of information

We reproduce here the part of the judgment given by Chakravarti, C J , which is really worth reading ' The Companies Act, therefore, provides for the employment of an auditor who is the servant of the shareholders and whose duty it is to examine the affairs of the company on their behalf at the end of a year and report to them what he has found That examination by an independent agency such as the auditor is practically the only safeguard which the shareholders have against the enterprise being carried on in an unbusinesslike way or their money being misapplied or misappropriated without their knowing anything about it The Act provides the safeguard in two forms It makes it the duty of the auditors to give an expression of opinion on certain specified matters of a vital character and it makes him liable, along with the directors, for misfeasance, if he fails to perform his duties as required by law and the approved audit procedure It is now well settled that it is the duty of an auditor to verify not merely the arithmetical accuracy of the balance sheet but its substantial accuracy and to see that it includes the particulars required by the Articles and the statute and contains a correct representation of the state company's affairs An auditor's duty is to see what the state of company's affairs actually is and whether it is reflected truly in the accounts of the company upon which the balance sheet

1 Matter No 71 of 1955, In the matter of Chartered Accountants Act

and the profit and loss account are based, but he is not required to perform the functions of a detective As has been said, he is a watch-dog and not a bloodhound and, as the same thing has been said without the aid of a metaphor, his duty is verification and not detection, although in performing the duty of verification he must employ reasonable care and skill What is reasonable care and skill must depend on the circumstances of each case Where there is nothing to excite suspicion and there is an atmosphere of complete confidence, based on the record of continued success in financial matters less care and less severity of scrutiny may be considered reasonable, whereas reasonable care and skill may be regarded as not exercised when, in spite of the presence of unusual features in the accounts or other *prima facie* reasons for believing that the affairs of the company may not be in order, the examination is perfunctory and not sufficiently detailed If such circumstances, that is to say, when the subject-matter is one which is not capable of direct verification and when to verify properly the result presented in the balance sheet, it would require investigation rather than checking and where there is nothing at all to excite suspicion, if in relying upon the statements in such circumstances, the auditor is himself deceived, he will not be held to have failed in the discharge of his duties

"The audit with which we are concerned in the present case is the audit of a banking company Such an audit has been called a balance sheet audit, meaning thereby that it is primarily confined to the verification of the existence of assets shown in the balance sheet, because on account of the multitudinous character of the transactions of a bank, it is not ordinarily possible to examine every one of them, nor is it usually done except with reference to matters, if any, which provoke enquiry *Vis-a-vis* the shareholders, the auditor holds a position of trust and it is his bounden duty to honour that trust being candid with the shareholders and telling them frankly and fully everything with regard to the affairs of the company which has come to his knowledge and which it is material for the shareholders to know Authorities, both legal and professional, are unanimous that in a bank audit, the cash balance claimed by the management must be verified by the auditor, because otherwise the management might remove the greater part of the funds and show them falsely as lying in hand in cash and thereby relieve themselves of the necessity of even making up accounts, showing the disposition of money . Inspite of having felt these doubts and such uneasiness, the respondent did not inform the shareholders frankly and directly what the facts were which had caused misgivings in his minds, but he chose to employ some euphemistic or enigmatical language which might or might not be taken by the shareholders to be of any significance and which certainly conveyed no definite information "

Deputy Secretary to the Government of India, Ministry of Commerce and Industry *v* Shadi Lal Batra[1] (1960)

The respondent who was practising as a Chartered Accountant

1. (1961) 31 Comp Cas., p. 271.

and was a member of the Institute of Chartered Accountants of India, was appointed liquidator of a company He failed to file the annual statement prescribed under section 224 of the Indian Companies Act, 1913 for the years 1951 to 1955 Disciplinary proceedings were initiated against the respondent, who claimed that he did not file the statements as he was doubtful whether he had the necessary authority to do so His appointment had been challenged in Court but the Court upheld his appointment although it observed that there was some irregularity in his appointment

Decision It was held that the failure of the respondent to comply with the provision of Section 224 of the Indian Companies Act, 1913, amounted to misconduct and attracted the disciplinary jurisdiction of the Institute The fact that there was some doubt in regard to the validity of his appointment as liquidator was not a sufficient ground for failure to comply with the section, particularly when, during the relevant period, he was acting as liquidator of the company This conduct, however, did not render him unfit to be a member of the Institute

Registrar of Companies, Kerala *v* P Arunajatai[1] (1962)

In this case the following charges were laid against the auditor:

(*a*) The first charge relates to the Balance Sheet of the year 1956. A sum of Rs 11,90,081-5-7 was written off in the Profit and Loss Account of the company for the period ended 31st December, 1956 The sums in question consisted of six items and, the auditor did not investigate the accounts to find out whether the various amounts that were transferred against the managing agents were properly done

(*b*) The second charge relates to the failure of the auditor to investigate the existence of cash vouchers for payments made by the company during the year 1956 to the extent of Rs 37,000

(*c*) The third charge relates to certain unauthorised loans made to Alagappa Chettiar College Endowment Trust.

(*d*) The fourth charge concerns the Balance Sheet of the year 1955 which showed that certain shares owned by the company in another company were fully paid up while in fact it was not so

(*e*) There was a further charge in regard to the omission on the part of auditor to verify certain stock entries

Decision It was held that where large sums of money due from others are consolidated and written off as bad debts in the Balance Sheet of a company for one year while the very same debts in the Balance Sheets of previous year were shown as good ones, the auditor

1. (1962) 32 Comp Cas, p 1153.

is bound to investigate into the circumstances leading up to the ing off of such debts, to ascertain whether there were voucher for debts and, if he is of the opinion from the vouchers maintaine respect of those debts that they were valueles, to disclose that fac his report to the shareholders He should not give a clean certifi to the Balance Sheet Even if there aré vouchers whch are appare regular, it is necessary for him to see that those vouchers are for amounts received and were given by persons entitled to bind debtor where the debtor is a company

The writing off of debts as irrecoverable might be justified it is the auditor's duty to investigate why they came to be treated bad He should first check the existence of the debt itself and enquire into the circumstances that led to its being treated as a debt.

Where a debt is shown as doubtful in one year, the same is shown as good for subsequent years and in a still later year written off, it is the duty of the auditor to enquire into the ma and make a reference to it in his report

It is the duty of an auditor (*i*) to inquire into the circumsta under which transfers of liabilities are made and investigate accounts to find out whether the amounts were properly transfer (*ii*) to verify whether advances have been made with proper sanct (*iii*) to verify the existence of assets and not to assume as true particulars given in earlier Balance Sheets and the work of person management of the company

The Attorney General of Kenya *v.* V B. Joshi[1] (1968)

The auditor, Shri V B Joshi, has been a Member of the tute ever since it was established For quite some time now he been practising at Mombasa The address of his place of business India furnished by him is "Care of Messrs Sapat & Co , 113, C Street, Bombay-2 " On 8th June, 1964, the Attorney Genera Kenya forwarded a complaint against the respondent, complai that the respondent has prepared a false Trading and Profit and Account for Messrs Mombasa Ration Stores for the year 1 60, that it was falsely prepared to the knowledge of the respondent had also prepared at false Balance Sheet for the said firm which fictitious for the year 1960

Decision. It was held that the Chartered Accountant guilty of professional misconduct and that his name should removed from the membership of the Institute for a period of years

Director of Accounts Gujarat State, Ahmedabad *v* K D Patel[2] (1968)

In this case the respondent was found guilty of profess

1 The Chartered Accountant, Vol XVI, June 1968, p 681.

2. Chartered Accountant, Vol XVI, Part X, April 1968, pp. 572-73.

misconduct under Section 21 of Chartered Accountants Act, 1949

The respondent was engaged to prepare Balance Sheet of a public trust which runs Khadisabhai Maternity Home, Sidhpur, for the year ended 1956, 1957, 1958 and 1959, and in the course he submitted the Balance Sheet along with the reports in respect of the said years to the Charity Commissioner, Except for certain observation made by him for the year ending 31-12-1957, the reports which were submitted to the Charity Commissioner were clean reports The Charity Commissioner, however, ordered special audit in respect of the four years by the firm of M/s C C Chokshi & Co, who were appointed Special Auditors They submitted their reports in which they pointed out several discrepancies On that a complaint was made to the Institute on 26th September, 1962

Decision. It is held that none of the charges for which the respondent has been found guilty savours of moral turpitude and, therefore, it was ordered that the respondent be reprimanded in respect of the charges for which he has been found guilty

Institute of Chartered Accountants of India *v.*
P K Mukerji & another (1968)

In this case Chartered Accountant was held guilty of professional misconduct under clause (O) of the Schedule to the Chartered Accountants Act, 1949

Anand Bazar Patrika Ltd is a joint stock company and has got an employees' Provident Fund Scheme which was being managed by the Board of Trustees The respondent is a Chartered Accountant and was appointed by the Board of Directors of the company to audit the accounts of the Provident Fund for the years 1953 and 1954. It appears that in year 1954 the Trustees of the Fund had made certain advances amounting to about Rs 6,21,864/- to the company in contravention of the Rules of the Fund The Directors of the company issued various cheques in repayment of advance, but at the request of the management of the company the cheques were kept with the trustees of the Fund uncashed and not credited in the account of the Fund After receipt of the cheques the Trustees of the Fund made book entries showing the repayment of the loan so granted to the company, though in fact none of these cheques had been cashed when such entries were made The auditor wrote about this to the company as follows

> "It appears that certain loans were granted by the Trustees of the Fund to the company in 1954 which although adjusted within the accounting year, do not appear to be in accordance with the Provident Fund Rules We disapprove such transaction and believe it will not recur in future Cheques issued by you to the Fund should also be cleared promptly"

1 Chartered Accountant, Vol, XVI, Part X, April 1968 pp 573-77.

The auditor signed the statement of accounts ending Decem 31, 1953 on May 14, 1954 and the statement of accounts end December 31, 1954 on June 30, 1955 But after signing the statem he gave the following certificate

"Checked with the books and accounts produced and correct"

Decision In the course of judgment, Ramaswami J, "It is not correct to say that Respondent No 1 owed a duty only Company which had appointed him to perform the auditing contributors to the Provident Fund had a beneficial interest in Fund and the primary object of auditing the Fund was to appra them of the true financial position of the accounts and investmen made from time to time Respondent No 1 therefore owed a duty the contributors to the Provident Fund for making a true report them of the financial position In other words, the auditing was tended for protection to the beneficiaries and the auditor was ted to examine the accounts maintained by the trustees with a to inform the beneficiaries of the true financial position The audit is, in such a case, under a clear duty towards the beneficiaries probe into the transactions' and to report on their true character our opinion, the legal position of the auditor in the present case similar to that of the auditor under the Companies Act, 1956. In a case the auditor is intended for the protection of the sharehold and the auditor is expected to examine the accounts maintained the Directors with a view to inform the shareholders of the financial position of the company" -

The auditor was held guilty and was ordered to be severe reprimanded for professional misconduct.

APPENDIX II

Practical Problems

1 What precautions should be taken by an auditor to guard against the disadvantages of a continuous audit ?

The following precautions should be taken to guard against the disadvantages of a continuous audit

(*i*) The auditor should issue instructions to the client's staff that no alteration should be made in the figures already audited and passed by him If any correction is needed later on, it should be made by passing an entry in the Journal

(*ii*) He should use different ticks for checking purposes, specially for erased or altered figures He should not pass on the secret meaning of such ticks to the client's staff

(*iii*) He should postpone the checking of impersonal accounts until the final audit at the end of the year This is to guard against usual types of manipulations in personal accounts which may be easily concealed by a making fictitious entries in the impersonal accounts In case such postponement is not convenient because of being voluminous, he should take notes of all the totals of Impersonal Ledger upto a date to which he has checked it Later on, he should verify such totals to ensure that no changes have taken place

(*iv*) The same check should, as far as possible, undertake audit from period to period making careful notes of all important matters, specially where manipulations are possible

(*v*) Proper notes should be made of all the relevant and important points in the Audit Note Book up to the end of the period under review Later on, they should be verified

(*vi*) Proper and careful supervision of audit work must be carried on by the principal auditor so that there may not be any lack of continuity in the work and overlooking of any important point

2 What do you mean by test checking ? Explain its main objective

Meaning of Test Checking Test checking implies detailed examination of a limited number of accounting data selected on random basis from the total accounting data This has become necessary as today in a large business undertaking, it is rather impra-

ctiable for an auditor to check all of the numerous transactions recorded in the books of accounts It is not only impractical from economic point of view but unnecessary as well, since management today ensures the accuracy of accounts to a great extent through effective application of internal control L R Dicksee, in this connection, states that "The theoretical responsibility of the auditor extends ultimately to every entry in the books of account, but it does not follow that it is either necessary or possible to examine every entry in detail" Thus, it has become a practice today to carry on test checking of the accounting data of a large concern

Principal or main object of test checking The principal of main objective of test checking is to draw some valid conclusions on the accuracy of the record by detailed checking of only limited number of accounting records drawn from the total accounting data with a view to save time as well as cost Thus, the idea is not to waste time and energy on the large mass of repetitive data recorded in the books of accounts

3 Describe the precautions to be taken before applying test checking What are the items not suitable for it ?

Precautions before applying test Checking An auditor should be very careful while applying test checking, as he cannot take a plea that he did not check certain records, as he undertook only test checking Therefore, he must take the following precautions before he applies test checking for audit

(*i*) The auditor must review the system of internal check, internal audit or internal control thoroughly. If he finds that the internal control system is either defective or ineffective, he should not apply test checking

(*ii*) He should apply test checking if he finds that the transactions to be checked are homogenous in nature He should not, in general, adopt test checking if the transactions are dissimilar in nature

(*iii*) The sample of records, selected for test checking, should be taken on random basis and should, be, as far as possible, representative in character

(*iv*) There should be no element of bias or arbitrariness in the selection of sample

(*v*) In case the auditor finds that there is a change in the personnal or in documents-flow, the sample selected for the test checking should include fairly large number of transactions of the period, both before and after the change

(*vi*) The auditor must always review the results of test checking with a view to find whether there is any further scope of checking records, not checked so far The nature of errors detected through-test checks may reveal this, if they are probed carefully

Transactions not suitable for test checking Following are the transactions which are not suitable for test checking and, therefore, the auditor should examine them in detail :

(i) Opening and closing entries

(ii) Bank reconciliation statement

(iii) Matters involving estimation as well as computation, *e g*, depreciation, royalty etc ,

(iv) Presentation and disclosure of information in the profit and loss account and the balance sheet

(v) Items which are material or which have material effect on disclosure in a financial statement

(vi) Transactions which may be small in number which may be important

(vii) Transactions which are recognised by law to be looked into by the auditor carefully, *e g*, managerial remuneration and purchase transactions etc

(viii) In case of seasonal industry, the auditor should not resort to test checking on annual basis.

(ix) Transactions of non-recurring nature or exceptional transactions need not be test checked.

4 Discuss the advantages and limitations of test checking

Advantages Test checking offers following main advantages

(i) It helps auditor in completing the audit work in a short period with lesser strains on him

(ii) He is able to complete the audit of accounts of many concerns within stipulated time.

(iii) It saves time and energy of auditor from the detailed audit of a large mass of repetitive data and, thus, it enables him to devote more time and energy on important matters

(iv) It ensures the accuracy of books to a large extent

(v) It keeps the client's staff alert as they know that any entry recorded by them may be taken for checking by the auditor

Limitations Inspite of the advantages, as mentioned above, it suffers from following limitations also

(i) It may result into failure to detect errors or frauds as the samples selected for test checking ma not include them

(ii) There is a possibility that the auditor may not be able to get the correct position of financial state of affairs of the concern, if he applies test checking With the result, his report may not be correct and duly reliable

(iii) It also increases the responsibility of auditor to a great extent, as he may be held liable for negligence in case of subsequent detection of frauds etc

5 Can the statutory auditor rely upon the internal audit in carrying out his functions as a statutory auditor ? State briefly what are the matters now to be included in the Auditor's Report in respect of the internal audit system of a large manufacturing company

It is for the statutory auditor to decide, where an internal audit is carried out, whether and to what extent, consistently with his statutory responsibilities, he can rely upon the work of the internal auditor in order to reduce the extent of his examination of details

His decision in this matter will depend upon his judgment on the facts of each case, having regard in particular to the following —

(i) The extent and efficiency of internal audit In order to assess these matters the statutory auditor should examine the internal audit programmes, working papers and reports and should make such tests as he thinks fit of the work done by the internal auditor

(ii) The experience and qualifications of the internal auditor, and his staff and the character of their reports as also the action taken by management on the basis of the report

(iii) The authority vested in the internal auditor and the level of management to which he is directly responsible

However, the statutory auditor cannot, in any circumstances, divest himself of the responsibilities laid on him by the statute In other words, if the statutory auditor had curtailed the extent of his checking, putting reliance on the work of the internal auditor, the responsibility for any deficiency in the financial statements that may remain undetected will be of statutory auditor He cannot plead that he had relied upon the work done by the internal auditor

The Manufacturing and Other Companies (Auditors' Report) Order, 1975, which came into effect from 1 1.1976 requires that the Auditors' Report shall include a statement in relation to companies the paid up capital of which at the commencement of the financial year concerned exceeds Rs 25 lakhs, whether the company has an internal audit system, commensurate with the size and nature of its business

6 In a large manufacturing concern, the management suspects inclusion of "dummy' workers in Wages Sheets What would you suggest to avoid or detect such records in them ?

With a view to guard against inclusion of the names of dummy workers in the Wages Sheets, suitable internal check system should be adopted It must have regard to the nature and technicalities of the factory concerned Following outlines of the system, however, are suggested

(i) Use of time recording clocks or some such other device for recording the correct attendance of the workers They should be installed at the gate as well as at each section or department

(ii) Each worker should be provided with a time card or job card as the case may be Proper records in detail about each worker must be maintained in such cards The foreman incharge should initial the entries in the cards. At the end of the week or month, the cards should be sent to Wages Office

(iii) Proper records related to overtime authorised and granted to the workers and pass-outs must be maintained

(iv) Due care should be taken in the preparation of Wages Sheets They should not be prepared by those who were responsible for recording the attendance of the workers Division of work with regard to making entries in Wages Sheets should be properly made One assistant should compare the records at the gate and Wages Office and should check the differences, if any Another assistant should enter the names, number, hours worked, rate of wages etc A third assistant should calculate the net wages to be paid to the workers after making deductions, if any The Wages Sheets should be cast by another clerk Each clerk should put his initials against the work done by him. Then the Works Manager should check and countersign it

(v) Payment of wages should not be made by those who took part in the preparation of Wages Sheets It should be done by the cashier in the presence of a responsible officer and also the foreman who recognises the workers Advances to the workers should be discouraged Payment of wages to the absentees should be made by a special arrangement and not to anybody who may claim on behalf of the absentees

(vi) For casual workers, separate records should be maintained They may be paid daily, it will be preferable if they are also paid along with regular workers

7 **Mention three frauds that are possible in credit sales and state in what way an auditor should proceed to detect them ?**

In credit sales there may be a possibility of the following three types of frauds

(a) Removal of unpaid invoices and misappropriation of the payments received

(b) Misappropriation of goods returned from the customers

(c) Inclusion of fictitious sales to inflate profits

To detect them, the auditor should proceed as follows in each case It is, however, to be noted that a proper system of internal check, effectively enforced, can be great help to avoid or detect such frauds The auditor should enquire about the system in use and note its weakness

(a) If Control Accounts are maintained, test them exhaustively and see that the balances thereon agree with the aggregate of unpaid invoices and the credit notes in the relevant customers' folders In case of any suspicion, he should write to the customer concerned ascertaining the balance which remains unpaid and then compare it with the records. If the payment has been already made by him but that has been misappropriated, it can be verified with the statement received from the customer

(b) To detect misappropriation of goods returned from the customers, ascertain the system of recording the goods returned and find out its weaknesses, if any Check exhaustively in the direction where there are greater chances of any fraudulent practices Check the entries in the Sales Returns Book with Goods Inwards Book

Refer to the correspondence entered into between the client and the customers returning the goods Check all credit notes carefully with the correspondence, Goods Inwards Book and the gate-keeper's records

(*c*) To check inclusion of fictitious sales with a view to inflate profits, check the sales invoices carefully Check particularly the sales entered towards the close of the accounting period with a view to find whether sales relating to the succeeding period have been treated as sales for the current period Check that sales made on the basis of 'sales or return' have not been included in sales unless the customer has approved it Ask for a schedule of such goods in the hands of the customers and check them carefully If any suspicions arises, correspond with such customers to ascertain the real position Check the Goods Outwards Book and gate-keeper's record exhaustively with the related invoices to see that only real sales have been included in the Books

8 Your client, proprietor of a big retail store, wants protection against losses of sale proceeds The client deals mainly in cash sales. Suggest a suitable system of internal check for the same

With a view to protect against the misappropriation of case out of the sale proceeds by the salesmen, the following system of internal check is suggested

(*i*) Complete segregation of responsibilities of the salesmen, the cashier and the accountant Neither the salesmen should be allowed to handle cash and have access to the Cash Book, nor the cashier should undertake sales

(*ii*) For each section, counter or department, separate salesman should be appointed

(*iii*) As far as possible, Cash Register should be maintained It should have the devices for tabulating the sales of each salesman with 'secret' totals attachment For daily comparisons, totals should be entered in a specially ruled summary sheet.

(*iv*) The salesman dealing with the customer should issue receipts in triplicate He should hand over two copies to the customer and retain one copy with him

(*v*) These two copies of the receipts, including the original, should be presented by the customer to the cashier, whose counter should be near the gate of the store.

(*vi*) The cashier should check the receipts, receive the payment and stamp the receipts as ' paid" Original copy of the receipt should be handed over to the customer

(*vii*) The customer should collect the parcel of goods purchased on presentation of the receipt, stamped as "paid", from another counter near the gate

(*viii*) Each salesman should prepare the summary sheet with the hope of the copy of receipts that remain with him

(*ix*) The cashier should enter the day's total sales in the Cash Sales Sheet with the help of receipts retained by him

(*x*) The General Manager should be reported about the total daily sales by the cashier Each salesman and to the gatekeeper should report about delivering the goods to the customer

(*xi*) Any discrepancy, found by the General Manager, should be properly dealt with by him

9 As an auditor, how would you safeguard against payment for the fictitious purchases while verifying the purchases ?

The auditor has to be careful while verifying the purchases that no payments have been made for the fictitious purchases. For this he may have to take the following steps

(*i*) He should examine the internal control system in this connection and satisfy himself with regard to its effectiveness He should ensure that before passing the invoices for payment, they are checked with the original order, with goods received book and stock records It should be seen that prices have been charged at the agreed rate

(*ii*) He should inspect the invoices and see that the authorities responsible for passing them for payment have duly checked them and initialled

(*iii*) He should test check the invoices to see that dates in the invoices are for the period concerned and they have been addressed to the client's concern It has also to be ensured that invoices are for the goods normally dealt with in the concern

(*iv*) He should compare a large number of invoices with the records in the goods received book and stock records.

(*v*) He should make physical verification of the goods purchased, if a part of them is still in the stock

(*vi*) He should compare the suppliers' statement with the suppliers' accounts and find out if everything is alright

(*vii*) Posting in the various suppliers' account should also be duly checked and compared with the statement received from them

10 What is a joint Audit? Discuss whether the liability of joint auditors is joint or several

Meaning of Joint Audit An audit is said to be joint audit when two or more persons or firms of Chartered Accountants are jointly appointed to conduct the audit of a company The practice of appointing joint auditors has been adopted by large sized companies, which want the pooling of resources of two or more auditors so that the audit work may be undertaken effectively, expeditiously and quickly Now-a-days most of the large companies do not appoint single auditor but joint auditors These joint auditors stand on equal footing so far as the professional work of audit is undertaken by them It is notable that the Companies Act, 1956 is silent on this question It has not yet recognised this development

Liability of joint auditors Section 227 of the Indian Companies Act does not contemplate and division of work of audit between two

or more persons Thus, according to the provisions of this section, the joint auditor has an individual responsibility only Otherwise also, it is not quite proper to hold an auditor responsible for the work not done by him but by another auditor If there are two auditors and both of them are held responsible jointly, that would create many practical problems

While the Companies Act is silent on this issue, the Institute of Chartered Accountants of India has issued a *Statement on the Responsibility of Joint Auditors* In this Statement, this issue has been discussed It has been made clear in it that it would not be correct to hold an auditor responsible for the specifically allotted work of another Each joint auditor will be responsible only for the work allocated to him In case the work can be easily and clearly divided on the basis of identifiable operating units or specified areas of work, the responsibility to perform the work assigned to one of the joint auditors with reasonable care and skill will be his alone The reason assigned for this is that the extent of audit work to be carried out is a matter of professional judgment and it may differ from auditor to auditor as no two firms or individuals will exercise this judgment in a similar fashion Thus, according to it, we cannot hold an auditor responsible for the work done by another auditor who is equally qualified and competent to undertake the audit work This also makes it clear that where the work cannot be clearly divided, the responsibility will be joint between them.

11. Explain the following

(i) *Surprise check*;

(ii) *Verification in depth.*

Surprise check. Earlier, an auditor used to depend much upon surprise check and it was one his strategies to check the records Today, the situation is much different and surprise check is seldom undertaken However, surprise check is the inspection of assets, e g cash stocks, investments etc , which are liable to be misappropriated by the person who has their custody An auditor generally makes a a surprise check with a view to verify cash balances, so as not to give time to the cashier or cashiers to make good the amounts which they might have misappropriated or lent out to a person without authority Surpise checks can also be made with a view to sec whether books are maintained up-to-date or whether internal controls are properly and effectively functioning Such checks may undoubtedly keep the employees alert in their work

Verification of depth Verification in depth is an important audit procedure which is normally used when the matter has to be probed to the maximum possible detail It involves tracing of a transaction through the different stages from its initiation to its conclusion The records and supporting vouchers applicable at each successive stages are examined to an appropriate extent, bearing in mind the quality and effectiveness of internal check operating at that stage For instance, the verification of payment made to a creditor for goods supplied is frequently carried out by simply examining the

receipt of the payee Verification of this transaction in depth, however, would involve examination of the following items

(*a*) a copy of the original order and authority therefor,

(*b*) the goods received note, and evidence that the goods had been examined to ensure their conformity with the original order, both as to quantity and quality,

(*c*) the supplier's invoice and statement,

(*d*) evidence in the stock records of admission of goods into stock

There is no fixed procedure to undertake verification in depth The procedure is quite flexible and could be adopted to suit any particular class of transaction

12 What will be the duty of an auditor for a difference in the books which remained undiscovered of the time at audit ?

An auditor's duty in such case would depend upon the circumstances of each particular case Even then he should make efforts to investigate such difference in the books with due care

He cannot, of course, carry on a detailed checking specially in case of large concerns to ensure the arithmetical accuracy in the books of account He may rely on test check But the should arrange his test-checking in such a manner so that the difference may be discovered during the course of audit or alternatively, reduced or localised Thus, he should ensure that large errors or frauds are at least brought to notice.

In case he is unable to trace the difference, he may transfer the amount of difference to a "suspense account" provided he feels that the difference is not really serious

He should report the matter to his client In case of a company, the matter should be reported to the director concerned He may make suggestions for making improvements in the internal check or book keeping system if the difference has arisen because of their weaknesses Unless the difference is so material which may result into serious misappropriation of facts in the Balance Sheet, he need not bring the matter to the notice of the shareholders of the company

It may be noted that it is not the general duty of an auditor to balance the books of account If he does so, he undertakes this work as an accountant and charges extra fees for it

13 The Trial Balance of a firm does not agree on account of certain errors You, as an auditor, are called upon to locate errors How would you proceed?

It is to be noted at the outset that it is not our duty as auditors to locate errors, if the Trial Balance does not agree If specifically called upon to do so, we should—

(*i*) Check the transfers from various accounts in the Ledger on to the Trial Balance to ascertain that all the balances have been transferred It is possible that some of the balances might have been

left from being transferred

(ii) Compare the various items in the Trial Balance of the current year with that of the previous year and see that all the usual items have been included therein

(iii) Check the totals of various subsidiary books and see that they have been duly transferred to the Trial Balance

(iv) See that the debit and credit items have been shown in their respective sides correctly

(v) See specifically that the balance of the Cash Book has been shown correctly in it

(vi) Check the balances of various accounts and see in particular whether the opening balances have been brought down in the accounts or not

(vii) Check the totals of both the sides of the Trial Balance

(viii) Find out the difference of the totals of both the sides the Trial Balance Half the difference and see if there is any item this value to find out whether any item of debit side has been on the credit side and vice versa. Similarly, double the difference and check it with several accounts

(ix) Check the totalling if the error amounts to Rs 1 or 10 100 or any round figures If the error is divisible by 9, it may because of misplacement of or transposition of figures, for instance 41 for 14 or 89 for 98 etc

(x) If the errors are not traceable, transfer them to suspens account which should be closed later, when they are discovered.

14 How would an auditor proceed in the following circum stances

(a) No vouchers are available for some payments
(b) Endorsed cheques have been filed as receipts
(c) Receipts of amounts exceeding Rs 20/- with revenue stamps affixed.

(a) In case no vouchers are available for some payments, auditor must challenge them and demand necessary vouchers may, however, not pursue the matter if the sum involved is small the expenses are explainable, e g , expenses in connection with or tram fares etc Anyway, he must seek proper explanations these cases also and suggest the keeping of a proper and separat record If he does not feel satisfied with the explanations offered should seek secondary evidences in that connection

(b) In general, he should not accept the cheques as an eviden for some payments In case of payment for a purchase, he shou satisfy himself with the inspection of invoice He should compa it with the entry made in the Ledger to the credit of the supplier account If he does not feel satisfied with this, he should pond with the supplier and ask for receipts or a statement from directly.

Care should be taken by him while vouching items of Cash Book that any receipted statement has also not been passed through as a voucher for a duplicate entry therein

(c) The auditor may accept them and pass if he is satisfied with their genuineness It is to be noted that "The voucher may be perfectly good evidence of the payment and its purpose despite nonstamping, and the Auditor could not refuse it on that ground alone "

In case he has any suspicion about their genuineness, he must draw the attention of his client to this aspect

15 During the course of audit you find the following cash receipts.

(a) Policy monies,

(b) Proceeds from sale of fixed assets,

(c) Bills receivable, and

(d) Bad debt dividends

How would you proceed to vouch them

(a) *Policy Monies* It should be vouched with reference to the correspondence entered into with the insurance company in this connection The copy of receipts given to the insurance company should also be examined Any other document available in this connection should be called for and duly checked

(b) *Proceeds from Sale of Fixed Assets* It should be carefully vouched as it involves the receipts from the sale of fixed assets such as plant and machinery, land and building or investments etc, where the chances of misappropriation of the receipts are greater It should be vouched with reference to the correspondence, agent's notes or statement, contract of sale or any other related documents

(c) *Bills Receivable* Such receipts may be on account of the bills discounted or the payments received at the maturity of the bills When discounted through the bank, check the Bank Pass Book and entries made in the Cash Book Examine the bills Receivable Book and see that receipts from all the matured bills during the year have been duly accounted in the account books

(d) *Bad Debt Dividends* They should be vouched with reference to the counterfoils of the dividend warrants or other related documents Check carefully the amount of debts and the rate of dividend and see that the correct amount has been accounted for.

16 How would an auditor satisfy himself with regard to

(a) Cash in transit from branches

(b) Goods on consignment

(c) Allowances made to customers

(d) Payments under hire purchases

(a) Ask for the manager's advice in connection with the remittance under question and vouch with reference to the receipt of cash in the next year's Cash Book

(*b*) Vouch the goods sent on consignment with reference to the copies of pro forma invoices For checking the expenses thereon, examine the receipts for freight and insurance etc Examine the sale proceeds with the help of accounts of sales received Also vouch the agents' expenses accordingly For goods unsold at the date of the Balance Sheet ask for a certificate from the agents Check the values at which the goods unsold are being included in the final accounts

(*c*) Ask for the credit notes issued to the customers and check with the Sales Returns Book and Allowances Book Examine that the credit notes have been duly authorised by some responsible official In case of any doubt, examine the correspondence with the costomers in this connection Check the casts and the postings of the Sales Returns Book

(*d*) For vouching the payment under hire purchase examine the agreement entered into in this connection with the vendor For vouching the instalment and paid upto that date examine their receipts Check that the assets account has been debited with the cash value of the asset only and the amount of interest has been transferred to the Profit and Loss Account

17 While auditing accounts of a concern, an auditor finds that (*a*) the sales have been entered in the book with abnormally large amount in the closing month of the year and (*b*) purchase amounts entered during the same period are smaller How would he proceed to satisfy himself with the genuineness of such entries?

(*a*) The auditor, on noticing such a situation, should first make enquiries and seek explanations about the abnormal sales entered in the book in the closing month of the year. Such abnormal sales may be genuine and he should see if they are due to one of the following reasons:

(*i*) Increased seasonal demands of the particular product dealt with *e g*, increase in demand of cloth because of marriages etc

(*ii*) Huge sale because of Christmas festival in December, when the accounts of the concern are closed on December 31.

(*iii*) Huge clearance sale organised towards the close of the financial year

(*iv*) Volume of sales remaining more or less as usual, but amount of sales entered in higher because of abnormal increase in the prices of the commodity dealt with by the concern

If the auditor feels satisfied that the abnormally high amount of sales entered is because of one or several reasons mentioned above he should pass it. But in case he finds that no satisfactory explanations are available and such entries have been made simply to inflate the profits of the concern and to conceal the inefficiencies of the management, he must proceed cautiously to examine it

Then, he must vouch the sale transactions of that period exhaustively with the Orders Received Book, Goods Outwards Book

and copies of receipts issued to the purchaser He must see that proceeds from the sale or fixed assets, sales of goods received on consignment, goods sold on 'sale or return' basis not yet approved by the purchaser, goods sent on consignment etc have not been included in the sales Similarly, he must examine the sales of the period succeeding the close of the financial year to satisfy that sales of the corresponding or next year have not been included in it. To check the possibilities of omitting returns inwards, he must examine the credit notes and returns inwards of subsequent period thoroughly He should also calculate the percentage of Gross Profits to sales for 4 or 5 years and compare them Any discrepancy, revealed in such examination, must be brought to the notice of the client

(*b*) Purchases may be suppressed with a view to inflate profits. The auditor, thus, must see whether the amount of purchases shown is genuine or otherwise In case he suspects that it is not genuine, he must proceed as follow

(*i*) Vouch the purchases of the said period exhaustively It should be vouched with reference to Purchases Book, Order Book, Goods Inwards Book and Invoices

(*ii*) Check the purchases entered the period subsequent to the financial year carefully with a view to ascertain that purchases, suppressed in the previous years to inflate profits, have not been entered in the subsequent period

(*iii*) Examine that all the purchases returns have been correctly recorded with the help of Debit Notes, correspondence and Returns Outward Book Any discrepancy revealed must be reported to the client

18 An auditor of a limited company did not verify the investments; he inserted a note in the Balance Sheet—"Investments not verified" The shareholders approved and adopted the accounts at the annual general meeting Subsequently, it transpired that the investments were misappropriated and the company suffered a loss

Can the auditor be sued for damages for negligence or otherwise in the discharge of his duties ? State your answer with reasons.

In case of audit of books of account of a company, an auditor has to comply with the statutory duties as laid down in the Companies Act, 1956 Verification of investments is a very important duty of an auditor since it is an important asset shown in the Balance Sheet Without its verification, the auditor cannot give a report as required under the Act If he mentions the fact that he did not verify the investments, it would not relieve him from statutory duties imposed upon him Such duties can never be limited, though they may be extended

Under Section 543 of the Companies Act, 1956 also, the auditor may be held guilty for misfeasance or breach of trust in relation to

the company in the event of winding up, provided such misfeasance has directly resulted in damage to the company

Thus, the auditor will be held liable in this case as the company suffered a loss because of such breach of duty

19 How would you very the following assets

(*a*) Goods on sale or return,

(*b*) Goods in a bonded warehouse ,

(*c*) Unquoted share held as investment, and

(*d*) Loans to employees

(*a*) *Goods an Sale or Return* To verify this, we should verify ourselves with regard to the internal check arrangement in this connection and ask for a schedule of such goods in this hands of the customers on the date of the Balance Sheet We should examine the Sale or Return Book, if maintained in the concern The Goods Outwards Book and Goods Inwards Book should also be examined If such transactions are treated as ordinary sales and recorded accordingly, we should see that appropriate adjustment is made in the Sales Account so that the sales and debtors are reduced to their correct figures otherwise the debtor's balances would include the goods in the hands of the customers at selling price, and the sales would be inflated Check that the stocks in the hands of the customers are valued at cost or under as the case may be

(*b*) *Goods in Bonded Warehouse.* To verify the purchases of the goods in the warehouse examine the invoices related to them Obtain a certificate from the warehouse authorities to find out the presence of those of goods in the warehouse Ascertain that the goods are duly insured and all the charges are duly provided for. Check that the goods have been valued at cost or market price whichever is lower

(*c*) *Unquoted Share held as Investment* Inspect the broker's bought note and the correspondence in connection with the purchase of the shares Inspect the share certificate to verify their existence Ascertain the price at which the shares of the company are being transferred by entering into correspondence with the company concerned

(*d*) *Loans to Employees* Inspect the loan agreements or other documents signed by the employees acknowledging such loans Examine the securities if they are secured Consider the possibilities of bad debts, if any Try to obtain certificates from each employee stating debts due to them on Balance Sheet date

20 While auditing the accounts of a company, you are unable to verify the cash in hand at the date of the Balance Sheet How would you satisfy yourself as to its correctness ? Would you accept the certificate of the manager in this connection ?

If it is not possible to verify the balance of cash in hand at the date of the Balance Sheet, it would be better to instruct the client to deposit the whole cash in hand in the bank on that date and withdraw

on the opening date If the time is over and such instruction cannot be given, the Cash Book of the next period upto the date of the audit should be vouched and cash in hand on that date should be verified If necessary, there should be a surprise check of the balance of cash in hand on some other date also

It would not be safe to accept the manager's certificate in connection with the balance of cash in hand specially when the balance is exceptionally large If the certificate is wrong, the reponsibility will be ours and we may be held liable

21 While auditing the accounts of a firm, an auditor finds that his client has acquired assets on Hire-Purchase System Under such circumstances to what special points would he draw his attention ?

If an auditor finds that certain assets have been acquired by his client on the Hire-Purchase System, he should draw his attention to the following points, in particular

(*i*) The assets have brought into account at cash value only It is to be noted that if an asset is acquired on Hire-Purchase System, the purchaser is required to make payment in instalment which includes part of the cash value of the asset and the interest on unpaid balance to that date

(*ii*) The interest payable on each instalment should not be charged to Asset Account but be transferred to Profit and Loss Account If the whole of the interest is brought in account, it should be transferred to interest Suspense Account and the interest of a particular year only should be charged to Profit and Loss Account

(*iii*) Depreciations should be charged on the cash value of the asset purchased and not on the total instalment amount payable.

(*iv*) The asset should be shown in the Balance Sheet at its cash value minus the depreciation charged on the same

22. How should an auditor verify the following payments made by a limited company

(*a*) Underwriting Commission ,

(*b*) Purchase of share ,

(*c*) Purchase of machinery ?

(*a*) *Underwriting Commission* For its verification the Articles of Association should be consulted first to ascertain whether the company is authorised to pay it, and the permissible rate of such commission He should see the Prospectus and facts mentioned in it in this connection Inspect the agreements entered into between the company and the underwriter Check its payment with reference to receipts given by the underwriters Examine the Board's mintues and see the allotment of shares made to them In case the commission has not been paid in cash but in kind by allotment of shares to them, see the Board's minutes carefully in this connection and ascertain that contract has been duly filed with the Registrar in this connection See that such commissions are duly disclosed in the Balance Sheet till they are duly written off

(*b*) *Purchase of Shares* The company may purchase old shares through brokers or new shares issued directly from the company concerned If the old shares have been purchased, verify it with the Broker's Bought Note and the receipt from him Ascertain whether they have been purchased *cum-dividend* If it is so, see that proper allocation betwe n capital and revenue has been duly made while recording the same If new shares have been purchased, check the copy of application, allotment letter and receipts from the issuing company Inspect the shares personally to verify their existence In case they have been lodged with the bank, obtain a certificate from it in this connection See that they are free from any charge

(*c*) *Purchase of Machinery* See that such purchase is duly authorised and inspect the Board's minutes in this connection Check the invoice from the supplier and receipts issued by him for payment made Ascertain that expenses incurred in its installation have been duly capitalised Inspect personally whether the machinery exists with the company and is free from any charge. See that adequate depreciation has been charged at the end of the year

23 Explain the procedure for auditing the following items of balance sheet of a company

(*a*) Bank overdraft ,

(*b*) Investment in shares

(*a*) *Procedure for Audit of Bank Overdraft* The auditor should follow the following procedure to audit the bank overdraft, if it appears in the balance sheet of a company

(*i*) The auditor should refer to the Memorandum and Articles of Association to see the borrowing power of the company and note specially the restrictions, if any, in this respect

(*ii*) He should refer to the minutes of Board's meetings and verify the authorisation made by the directors for borrowing by way of overdraft from the bank He should also see the resolution for pledge, hypothecation guarantee etc.

(*iii*) He should examine the agreement with the bank in this regard and find out whether the overdraft is clean or given against pledge or hypothecation of the assets of the company He should also see if there is any collateral security in this respect

(*iv*) He should obtain confirmation in this regard from the bank and should check it with the help of bank's statement of account

(*v*) In case, the overdraft has been obtained against the hypothecation of assets like stock, he should obtain a certificate from the bank in this respect He should also find out whether such a charge has been duly registered or not

(*vi*) In case the overdraft has been obtained against the pledge of stocks, he should find out the arrangement in this respect.

(*vii*) He should check the accounts to find out that all the interests due on such a overdraft have been duly accounted for

(*viii*) He should find out all the terms of agreement in this respect and see that they have been duly observed by the company

(*ix*) He should see that the overdraft taken has been properly disclosed in the balance sheet of the company as required in the Schedule VI, Part I of the Companies Act, 1956

(*b*) *Procedure for audit of investment in shares* The auditor should take the following steps in connection with the audit of investment in shares

(*i*) He should refer to the Memorandum of Association to find out whether the company has power of making investment or not

(*ii*) He should obtain a list of shares held as investment on the date of balance sheet He should see that all the particulars such as, distinctive number, nominal value, book value, cost, quoted price, the year of purchase etc are given in such a list

(*iii*) He should refer to the Board's minute book to verify the authority for the purchase and sale of shares made by the company during the year

(*iv*) He should refer to the broker's bought note or the letters of allotment to check the shares purchased during the year

(*v*) He should see that provisions of Section 372 of Companies Act in this respect have been duly complied with and a register of investment is maintained as required under this Section

(*vi*) He should verify the payee's receipt for the amount paid and the share series

(*vii*) He should see that all the shares are held in the name of the company and there has been no violation of Section 49 in this connection

(*viii*) In the event of sale of some of the shares during the year, he should see that it has not violated the provisions of Section 227 (1A) (c) of the Companies Act

(*ix*) He should see that the shares have been valued and shown in the balance sheet at cost In case there is a substantial fall in their value, a provision for the same should be maintained

(*x*) He should check to find out that all the dividends on shares have been received or not and they have been duly accounted in the books

(*xi*) He should make the physical verification of all the shares held, preferably in one sitting, on the closing day

(*xii*) He should also see that the investment in shares has been shown in the balance sheet in the manner required in the Part I, Schedule VI, to the Companies Act, 1956

24 Discuss your duties if you find that there is a change in the basis of valuation of stock-in trade in a trading company

Any change brought about in the method of valuation of stock has significant effects on the final accounts of a business concern

Hence we should be very careful in this respect If we find that some changes have been made, a note should be put in the Balance Sheet about this fact and, if possible, its effects Sometimes, it is not possible to find out its effects on profits of the company, *e g* if there are various figures in the Profit and Loss Account based on profits such as managing agents' commission, provision for taxation or surtax on profits etc

We should be more cautious if we find that such change amounts switch over from one generally accepted method of valuation to another method of valuation There will, however, be no change in the method of accounting because of this In case the change is from a method not commonly accepted or a wrong one to a generally accepted method, it would effect the basis of accounting.

A note in the Balance Sheet should be given in the following form "The method of valuation of stock hitherto employed by the company was at 'adjusted selling price' From this year it has been changed to 'at cost or market value whichever is lower' Value of stock according to previous method would have been Rs . "

25 In the course of Annual General Meeting of a company a shareholder asks you, as Auditor, to explain why you have signed the Balance Sheet when the items on the asset side were not saleable at the amounts placed against them What would be the nature of your reply ?

So far as signing the Balance Sheet is concerned, we, as auditors of a company, as required to sign it under the Companies Act, 1956 irrespective of the fact whether it shows true and fair view or not But it appears from the question that the shareholder wants justification of issuing unqualified report when he feels that the assets are not worth the amount stated in the Balance Sheet In reply to this we have to say that the assets are not shown in it at the market value or the value at which they may be disposed off on the date of the Balance Sheet They are shown according to their worth to the company as a going concern It is not expected that the company will be liquidated soon and its assets will have to be disposed of, therefore, all the assets should be shown at their market value It is not the correct principle of Accountancy

In a Balance Sheet, there are different types of assets, for example, fixed, floating and intangible assets etc The fixed assets are never shown at the market value They are shown at cost less depreciation deducted thereon Similarly, the floating assets are shown at the cost or market price whichever is lower So far as intagible assets are concerned, they cannot be held to have any value apart from the business as a whole They may not realise the value at which they are shown in the Balance Sheet.

Thus, it would be apparent that the assets are not shown at their saleable value in the Balance Sheet, hence there is no question of their realising the amounts placed against them.

26 Distinguish clearly between 'confirmation' and 'physical verification' Mention three balance sheet items requiring confirmation by the third parties and three balance-sheet items requiring physical verification

To understand the distinction between the 'confirmation' and 'physical verification' clearly, let us make the meaning of the two clear

Meaning of confirmation. The confirmation implies those techniques adopted by an auditor by which he affirms certain facts or balances from certain competent parties The competent party may be any third party or the management itself Often, in practice, there is a need for such confirmation on the part of auditor. He may get such confirmation from the debtors, creditors, bankers, financial institutions, companys, brokers, etc , regarding certain assets of the company which may be in their possession with or without charge He may also need verification from them regarding certain transactions which might have been entered into between the company and those third parties

Sometimes the confirmation may be required from the management also For instance, if there is any contingent liability of the company, the auditor may require their confirmation from the management

Meaning of physical verification The physical verification is a process involved in the verification of certain assets of the company This is undertaken with a view to verify their physical existence Such physical verification can be undertaken in case of tangible assets only, such as, stock, investment etc This involves counting, weighting, identification and evaluation of the assets concerned

Examples of items requiring confirmation Following are examples of balance sheet items which require confirmation from the third parties

(*i*) Sundry debtors. which may be confirmed from various parties whom the goods might have been sold on credit

(*ii*) Bank balances for which the confirmation may be required from the banker of the concern

(*iii*) Investment scrips in the custody of bank which may be confirmed from the bank concerned

Examples of items requiring physical verification Following are the items which require physical verification on the part of the auditor

(*i*) Closing stock and stores of the concern

(*ii*) Investment scrips in possession of the concern

(*iii*) Cash-in-hand

27 How would you audit the transactions related to consignment in the books of (a) Consignor, and (b) Consignee ?

(*a*) *Audit of consignment transactions in the books of consignor.* The auditor has to take following steps for the audit of consi-

gnment transactions in the books of the consignor

(i) He should ascertain that only those profits have been credited which have been earned on the sale of goods through the consignee in the period concerned Goods unsold and lying as stock in the hands of consignee should be valued at cost and no profit should be credited on the same

(ii) In case the result of each consignment has to be worked out separately, the goods sent to the consignee should be debited, through consignment day book, to the Consignment Account The auditor should refer to the proforma invoice, consignment day book, goods outward book, transport documents, acknowledgement of the goods by the consignee and the Account Sales with a view to check the debits in each of the consignment account

(iii) the verification of the credit in the Consignment Account should be made with the help of the Account Sales received from the consignee It should be seen that the Consignment Account should be credited with the gross sales proceeds and that should be debited to the consignee's account

(iv) With a view to check the commission and other expenses, an auditor should refer to the terms of agreement between the consignor and the consignee For this, the Accounts Sales may also be referred to

(v) The balance in the consignee account should be confirmed through correspondence with the consignee

(vi) In case the goods have been despatched with the loaded price (which included some profit on cost), the auditor should see that it has been duly unloaded and brought to cost in the account

(vii) In case the goods sent on consignment are treated as ordinary sales, the auditor should see that necessary adjustments have been made in the accounts at the end of the years, specially with regard to the goods unsold, commission and other expenses incurred by the consignee It should also be seen that the consignee should not be shown as debtor for the goods unsold At the same time, it should also be seen that the goods unsold should be included at cost and on a consistent basis

(b) *Audit of consignment transactions in the books of consignee* The auditor should take following steps for the audit of transactions recorded in the books of the consignee :

(i) The auditor should see that the ordinary sale by the consignee and the sales carried on behalf of the consignor are kept entirely distinct and they should not be mixed together He should check the Consignor's Account and see that consignment sales have been credited to this account and not the Sales Account

(ii) The auditor should ascertain that stock unsold and related to the goods received from consignor should not be mixed with the stock of the consignee himself

(iii) With a view to check the treatment of commission and other expenses incurred on behalf of the consignor, he should obtain

copies of the Account Sales and terms of agreement and should check them accordingly Proper care should be taken for vouching the expenses It should also be seen that consignees own expenses and those incurred on behalf of the consignor are not mixed together

(iv) With a view to verify and confirm the balance in the Consignor's Account, a signed copy of the Consignor's Account should be obtained

28 How would you as an auditor allocate the following between capital and revenue

(a) Stock value at Rs 50,000 was destroyed and Rs 65,000 was recovered from the insurance company

(b) Loss on sale of machinery

(c) Alterations in plant and machinery

(d) An amount received as compensation for loss of goodwill to a business, the premises of which are required for road widening

(a) The whole amount recoverd from the insurance company should be transferred to the credit of trading account It appears that the book value of the stock was Rs 50,000 and the fair valuation of stock for which the claim from the insurance company was made had increased by the passage of time It is to be noted that there are some items such as rice, timber, wines and spirits etc, whose value increases as time passes

We should also make enquiries about the amount of claims made from the insurance company It is possible that the claims might have been made for a higher amount, say Rs 70,000 If we feel satisfied that the claim was based on fair and just valuation we should see that the amount received short, *i e* Rs 5,000 in this example, should be debited to Profit and Loss Account

(b) The loss on the sale of machinery should be debited to Profit and Loss Account or Reserve In case the loss involved is a huge amount, it should not be written off in one year but preferably spread over a number of years depending upon the volume of loss

(c) Any expenditure on alteration in plant and machinery should be treated as capital expenditure provided it results in improvment Usually, a part of expenditure on such alterations would be in the nature of repairs That should be properly estimated and charged to revenue and must be written off If it appears that the expenses incurred by way of repair are unduly heavy, that should not be written off in one year but preferably over a short period of years to equalise such burden on the Profit and Loss Accounts from year to year

(d) The amount so received by way of compensation for loss of goodwill is of capital nature and should not be transferred to Revenue or Profit and Loss Account If the Goodwill Account already exists in the books, this amount should be credited in that

account with a view to reduce its value In case no such account exists, it should be transferred to Capital Reserve

It should, however, be noted that if the business concern is completely wound up and does not continue business elsewhere, there will be no such problem of making a distribution of capital and revenue in connection with such receipts Thus the treatment of such amount, as described earlier, is based on the presumption that the business is being continued, though from some other premises

29 Chalk out an audit programme for a large manufacturing company with which, as an auditor, you are familiar

The various steps, which have to be taken by an auditor in auditing the accounts of a large manufacturing company, are as follows

(*i*) Enquire about the internal check system in use in the company Test it and find out the weaknesses, if any

(*ii*) Inspect various important documents such as Memorandum and Articles of Association Directors' and Shareholders' Minute Book, previous Balance Sheets, Auditor's Reports etc

(*iii*) Obtain a chart showing managerial duties and responsibilities

(*iv*) Check opening entries with the help of previous Balance Sheet

(*v*) Vouch all the receipts and payments carefully Special care should be taken in vouching of capital expenses and Cash Book.

(*vi*) Verify cash in hand, cash at bank, investments and other assets and liabilities

(*vii*) Examine valuation of various assets Note any change in the basis of valuation.

(*viii*) Verify and examine the valuation of stock-in trade carefully

(*ix*) Check Wages Sheets carefully.

(*x*) Examine costings, specially of raw material, work-in-progress and finished goods

(*xi*) See whether provisions of Companies Act have been duly observed or not

(*xii*) Compare percentage of gross profits to sales of current year to that of previous years

(*xiii*) Get any other information or explanation necessary

(*xiv*) Report to the shareholders

30 Draw out the Audit Programme of a Cooperative Society

The audit programme, in general, should contain the following points

(*i*) Examine regulations of the society and also the various provisions contained in the Cooperative Societies Act, 1912 or pro-

vincial legislation in this regard, if any, as they may affect the accounts of the Society

(ii) Enquire the system of internal check, if any, in use

(iii) Vouch cash received by way of share capital with reference to the Register of Members and copies of the receipts issued to them Check the subscriptions of non members, if any, that they are within the rules

(iv) Vouch receipts from deposits, if any, with the help of the copies of receipts issued and records in Cash Book therefor

(v) Vouch grants from the Government, if any, with reference to the letter authorising such grants

(vi) Check the money borrowed from the banks or Central Co-operative Society from the Cash Book and with the correspondence and other related documents

(vii) Vouch payments thoroughly

(viii) Vouch the receipts from interests on loans granted with the help of copy of agreement related thereto and see that all the interests have been duly recorded

(ix) Cast Cash Book and verify the cash in hand at the end of the financial year

(x) Verify the investments and see that they have been made according to the prescribed rules

(xi) Verify the stock thoroughly

(xii) See that Reserve has been created with at least 25% of the profits.

(xiii) Examine the payment of dividends to the members thoroughly.

(xiv) Satisfy that the accounts have been prepared according to the prescribed rules and show true and fair state of its affairs

(xv) Draft a report

31 Give your opinion whether the following persons can be appointed auditor or auditors of a limited company or not

(a) A firm of chartered accountants in practice, a partner of which is a secretary of the company

(b) A chartered accountant in practice owing Rs. 500 to the company

(c) A member of the Institute of Chartered Accountants of India, who is of unsound mind, holding a certificate of practice

(d) A chartered accountant in practice holding 7% of shares in a company which is the secretaries and treasurers of the company.

(a) The firm cannot be appointed the auditors of the company as one of its members is secretary of the company The secretary is an employee of the company and any employee of the company can-

not be appointed its auditor [Section 226 (3 b)]

(*b*) He can be duly appointed as an auditor of the company since he is indebted to the tune of Rs 500 only A person who owes to the company an amount exceeding Rs 1,000 only cannot be appointed as an auditor of a company [Section 226 (3d)]

(*c*) The member of the Institute of Chartered Accountants of India, holding a certificate of practice, can be appointed as an auditor of the company even if he is of unsound mind provided he has not been adjudged a man of unsound mind by a competent Court Therefore, so long as he has not been adjudged a man of unsound mind, he may be so appointed

(*d*) The chartered accountant holding 7% of shares of the company which is the secretaries and treasurers of the company cannot be appointed the auditor of the company as it has been prohibited under Section 226 (3f)

32 Shareholders of a company passed a resolution in its annual general meeting reappointing A as auditor and B as joint auditor for the current year They further resolved that if both or either of them declines assignment, the Board may fill up the vacancy The Board, subsequently decided to appoint C in case any of the auditors declines assignment A and B declined and C joined as auditor Is appointment of C legal under the provisions of Companies Act, 1956 ?

The appointment of C by the Board is not valid in this case Section 224 of the Companies Act, 1956 deals with the appointment of an auditor Under it, the Board of Directors can make appointment of an auditor if there is a casual vacancy or a vacancy caused by resignation In the case, the vacancy is neither casual nor caused by resignation It is to be noted that a 'casual vacancy, presupposes an existing appointment but in this case re appointment has never become effective Similarly, there is no case of resignation by the auditors

The shareholders, however, can authorise the Board to make an appointment in any circumstances which did not contravene Section 224, if the Articles of a particular company do not provide otherwise

Thus, the appointment of C is not valid It may be valid only if the action of shareholders in authorising the Board to fill the vacancy was not contrary to the provisions of the Articles of the company.

33 State various legal provisions which ensure independence of a company auditor

There are certain provisions in Companies Act, 1956 and Chartered Accountants Act, 1949 which ensure independence of an auditor

Under Section 226 of the Companies Act, 1956, the independence of an auditor is ensured by prohibiting appointment of a Chartered Accountants as an auditor of a company, if he is—

(*i*) An officer or employee of a company

(*ii*) A partner of a person in the employment of an officer or of an employee of a company

(*iii*) A director or a member of a private company or a partner of a firm or a director or shareholder having more than 55% of the shares of any body corporate, which is the managing agent or secretaries and treasurers of the company

(*iv*) A person who is indebted to the company for an amount exceeding Rs 1,000

(*v*) A person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs 1,000

A person who cannot be appointed as an auditor of a company because of the above disqualifications cannot be so appointed as an auditor of such company's subsidiary, co-subsidiary or holding company

Similarly, under Section 314 of the Act a person cannot be appointed an auditor of a company as usual if he is a relative of a director, managing agent, secretaries and treasurers or manager of the company Under such circumstances, he may be appointed as auditor of a company only if such appointment is approved with the consent of the company in general meeting obtained by a special resolution

In the Chartered Accountant Act, 1949, under paragraph 10 of the First Schedule, the acceptance of contingent fees by an auditor is prohibited Contingent fees implies those fees which are either based on percentage of profits or otherwise dependent on the findings or the results of employment Thus, this provision also ensures his independence

The Act, under Second Schedule, Part I para 4, makes it an act of professional misconduct of Chartered Accountant to express an opinion on financial statements of a business in which he or his firm or a partner of his firm has a substantial interest unless disclosure of such interest is made

34 State the liability of an auditor in the following cases citing relevant cases ·

(*a*) A Chartered Accountant sent circular letters soliciting work.

(*b*) An auditor failed to communicate in writing to the previous auditor of his appointment as auditor of a Cooperative Bank but such omission was not intentional.

(*c*) An auditor failed to report to shareholders of a company about the non-creation of a sinking fund in accordance with the Debenture Trust Deed and did make clear that the amounts shown as towards Sinking Fund were borrowed from the Managing Agents of the company

(a) Under clause 6 of First Schedule (Part I) of the Chartered Accountants Act, 1949, a chartered accountant in practice shall be

deemed to be guilty of professional misconduct if he "solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication of interview or by any other means"

In *M G G Gadre v W G Ambekar* (1952) a chartered accountant was held guilty of professional misconduct as he had printed card and circular letter soliciting work

In *Re K C J Satyavadi* (1955), a chartered accountant wrote to the Ministry of Commerce and Industry to enrol the name of his firm in the list of auditors maintained by the Department and was held guilty

In *Re G K Joglekar* (1957), a chartered accountant sent an application to the chairman of a Co-operative Society offering himself for appointment as an auditor It was held that the infringement was a serious breach of professional ethics

(b) In this case he will not be held guilty of professional misconduct as the omission was not intentional and it was simply a technical breach Under clause 8 of the Act an auditor should first communicate with the previous auditor in writing before accepting a position previously held by that previous auditor

In *S V Kharwandikar v D K Borkar* (1952), a chartered accountant failed to communicate in writing to the previous auditor of his appointment as auditor of a Co-operative Bank and such omission was not intentional It was held that the breach was only technical and that it was open to the High Court to order for a lesser punishment than removal of a member

In *B N Mohan v. K C J Satyavadi* (1955), a chartered accountant applied in response to an advertisement in a newspaper for appointment as auditor and was appointed by the Directors and failed to communicate with the previous auditor and ascertain from the company whether the requirements of the Companies Act as regards the appointment of the auditor were duly complied with It was held that he was guilty of professional misconduct

(c) The auditor will be held guilty of professional misconduct in this case also It is required under First Schedule (Part I) of the Act that he must disclose a material fact known to him which is not disclosed in a financial statment, but disclosure of which is necessary to make financial statement not misleading

In *Davar & Sons Ltd v M S Krishnaswamy* (1952), similar problem arose and it was held that the Chartered Accountant was duty bound to see that the nature and subject matter of the charge over a security and the nature and mode of valuation of the Sinking Fund investments were disclosed in the Balance Sheet in accordance with the prescribed form and was found guilty of charges

35 After completing the audit of a limited company for the first half year of its financial year, the auditor expires and in his place you are appointed to fill the vacancy State the extent to which you

would rely on the work performed by the late auditor while completing the years audit

The audit programme of the late auditor should be carefully consulted, noting the work already done by him. We should make a test checking of the audit work already undertaken and if we find that there is nothing wrong, we may leave the detailed checking of the same But if we find something lacking, we must check as exhaustively as possible to satisfy ourselves as to the accuracy of accounting records We need not carry on the routine checking already done in detail If the Audit Note Book is available, we should note important points, if any noted, and do the needful In fact the accounts are closed and balanced at the end of the year, and we should check the accounts of the later half of the financial year exhaustively But it should be noted that the ultimate responsibility of any discrepancy in accounts even for the first half of the financial year rests on us We cannot claim that such accounts were audited by the late auditor and not by us

36 Discuss the extent of liability of an auditor, in case it is ascertained subsequently that the accounts of that company which he had audited and certified were false or fraudulent

An auditor is expected to perform his duties with the highest auditing standards prevalent at that time He must take reasonable care and skill to satisfy himself as to the truth aud fairness of the financial state of affairs of the concern If he finds any irregularity in the accounts, he must draw the attention of the shareholders in clear words

In case irregularities in accounts are subsequently discovered, an auditor may or may not be held liable It will depend upon the circumstances of each case If it is proved that the auditor did not exercise reasonable care and skill as was required of him in that particular case and because of that the accounts remained false or fraudulent, he may be held liable In other words, if he fails to discharge his duties he may be held liable

It may, however, be noted that an auditor is not expected to do more than exercise *reasonable* care or skill He cannot be held liable for not tracing out ingenious schemes of frauds carefully laid down, specially where those frauds are perpetrated by the trusted servants of the company and there was nothing to arouse his suspicion

37 Discuss the liability of an auditor in the following circumstances:

(*a*) On the basis of the managing agents' certificate as to the valuation and verification of the stock in-trade, the auditor certifies this asset without making any further enquiries, despite the fact that at the time of audit a strong rumour was afloat that the managing agents have been manipulating the accounts year after year mainly by inflation of stock values

(*b*) The auditor has passed the purchase of a big land on the strength of a title deed produced to him by the managing director

of the company Subsequently, it transpires that the title deed was a faked document

(c) Pressed hard for time, the auditor resorts to test checking and thereby fails to detect certain errors and faults which otherwise would have come to his notice.

(a) An auditor may accept a trusted official's certificate with regard to valuation and verification of stock in-trade But if there is anything to arouse his suspicion, as in the present case, he must probe the matter in detail and resort to test checking to verify the stock. He would not have been held liable if he had taken reasonable steps and found the rumour baseless and accepted the certificate given by the managing agents of the company

(b) An auditor is not supposed to possess technical knowledge and it is not expected of him to know whether a title deed is a real or faked one. If the title deed is supplied to him by the managing director of the company, a trusted official of the company, and there was nothing to arouse his suspicion with regard to the genuineness of the title deed, he may accept it and may not be held liable even though subsequently it transpires to be a faked document

(c) There is nothing wrong if an auditor resorts to test checking, if scientifically done As a matter of fact, in case of a large business concern he has to depend upon it to a great extent as it is practically impossible for him to carry on the detailed checking of all numerous transactions So far as his liability for non-detection of certain errors and faults is concerned, it will depend upon the fact whether he exercised reasonable care and skill in checking the accounts according to the normal standard practice prevailing at the time He may be held liable if it is proved that he did not exercise reasonable care and skill in performing his audit because of which such errors and faults remained undetected

38 During the course of audit of a company an auditor finds that—

(a) Plant and Machinery have been shown in the Balance Sheet at Rs 40,000 after the depreciation although its market value is Rs 25,000 only,

(b) Goodwill stands at Rs 60,000 as usual and it has not been written off for last several years, and

(c) Profits on sale of Buildings have been credited to the Profit and Loss Account

What would be his duties in this connection ?

(a) If the Plant and Machinery have been adequately depreciated, their market value need not be taken into account It is because they are fixed assets held for increasing the earnings of the company and their earning capacity is not at all affected by fluctuations in their market value He has only to satisfy himself whether the depreciation charged is adequate or not If the fall in market value is heavy and permanent, a note may be given in the Balance Sheet in this connection

(*b*) A company is under no legal obligation to write off the Goodwill and, therefore, it may maintain it as such Moreover, the question of its depreciation does not arise But since Goodwill is an intangible asset, the company should make efforts to write it off as soon as possible gradually Thus, the auditor may simply advise to write it off but cannot compel to do so

(*c*) Profits on sale of Buildings earned by the company are not trading profits earned in the usual course of its business, but they are capital profits The capital profits, however, are not available for distribution as dividends and, therefore, he should object to crediting of this amount to Profit and Loss Account He may, however, allow it if the following conditions are fulfilled

(*i*) The company's Articles permit it,

(*ii*) Such surplus remains even after the proper revaluation of all the assets of the company

39 As an auditor, how would you satisfy that the following have been duly provided for—

(*i*) Reserve for Bad and Doubtful Debts ,

(*ii*) Outstanding Liabilities for Expenses , and

(*iii*) Provision for Depreciation

(*i*) To satisfy ourselves that the Reserves for Bad and Doubtful Debts have been duly provided, we should pay attention to the following points carefully

(*a*) The term of credit allowed by the concern and the debts which have exceeded those limits

(*b*) The age of the debts and whether any debt is sufficiently old and on that account how payment has been received during the period under audit

(*c*) Whether part payments on account are being received and in such cases, whether the balance shows a tendency to increase

(*d*) Whether any bill of exchange or cheque received has been dishonoured

(*e*) Whether there are certain accounts for which informations such as those relating to bankruptcy, liquidation, suspension, of payment accounts having been placed in the hands of solicitors are available

(*f*) The estimation of amount of bad and doubtful debts should be made by him and that should be compared with the List of Doubtful Debtors prepared and certified by some responsible official

If we find that inadequate provision for such debts has been made, we should request the management to provide for it adequately In case the management declines to do so, we must report the matter to the shareholders

(*ii*) We should see that all the expenses relating to the period under audit, whether paid or outstanding, have been duly brought into account We should pay particular attention to such expenses

which usually remain unpaid, *e g* audit fees, insurance premiums, water and electricity bill, interest on loans, wages and salaries, rents and taxes etc We should be careful about them while vouching the payments side of the Cash Book To ensure further checking, we should check payment side of the Cash Book for the commencement of the succeeding period We should, if necessary, ask for a certificate from some responsible official stating that all the expenses during the period under audit have been duly recorded in the books

(*iii*) As auditors we will have to depend upon the management or the expert's opinion as to how much depreciation should be charged on a particular asset It is difficult for us to assess the amount of depreciation which will reduce the value of the asset to its breaking value at the end of its life But if on the basis of the expert's opinion we find that the provision for depreciation made is inadequate, we must bring this fact to the notice of the client in clear words

40 Is an auditor of a limited company under any obligation to satisfy himself whether the Reserves for Bad and Doubtful Debts have been adequately provided for or not? Discuss with the help of legal decisions, if any, on this point

An auditor of a limited company is required to report to the members of the company with regard to the 'true and fair' view of its financial affairs A Reserve for Bad and Doubtful Debts is created to provide for any contingency arising from non-payment of money due by the debtors Debtors form an important item in the Balance Sheet of a company as a floating asset An auditor must satisfy himself with regard to the existence and valuation of various assets including Debtors. He may not feel satisfied with the amount of Sundry Debtors shown in the Balance Sheet, because he finds that the financial position of some of the debtors included in 'Sundry Debtors' is doubtful For instance, if the Sundry Debtors are of Rs 20,000 out of which it is expected that debtors owing Rs 5,000 would not be able to pay the full amount, the Balance Sheet would exhibit incorrect financial situation if the Sundry Debtors are shown in it with the full amount, i e Rs 20,000 Under such circumstances, he must see that adequate provision for bad and doubtful debts has been made What is adequate would depend upon the particular circumstances of each case

The following cases may be cited in support of what has been said above·

In *re London and General Bank*—(1895) the auditor was held liable, as he did not report to the shareholders the unsatisfactory state of "Loans to customers, and other securities" owing to the company.

In *A E Green & Co v The Central Advance and Discount Corporation Limited* (1920), it was held that an auditor is guilty of negligence if he accepts a Schedule of Bad Debts furnished by a responsible official although it is quite apparent that some of the debts included in the schedules are irrecoverable

In *Verner v General and Commercial Investment Trust Ltd* (1894), the question of depreciation of investment was considered It was held that "fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up" Though this case is not directly connected with the Debtors yet it has been clearly held that diminution in the value of the book debts must be made good before arriving at profits since they are normally floating assets

Thus, it is quite clear that an auditor must see that adequate amount has been transferred to Reserve for Bad and Doubtful Debts and if it is not done, he must report the matter to the members of the company

41 Explain briefly the requirements of Schedule VI to the Companies Act, 1956 regarding disclosure of the following items in the balance sheet of a company

(*a*) Reserves and Surplus

(*b*) Expenditure incurred in respect of salaries and perquisites of employees

(*a*) *Reserves and Surplus* The reserves and surplus have to be shown in the balance sheet under the following categories

(*i*) Capital Reserve,

(*ii*) Capital Redemption Reserve ;

(*iii*) Share Premium Account ;

(*iv*) Other reserves (with the nature of each reserve and the amount involved),

(*v*) Surplus representing the credit balance in the profit and loss account after providing for dividend, bonus and reserves,

(*vi*) Sinking Funds, and

(*vii*) Proposed addition to Reserves.

Any addition or deduction in the various categories of reserves and surplus during the year should be duly disclosed in the balance sheet against each item If there is any debit balance in the profit and loss account that should be shown as a deduction from the uncommitted reserves shown under the category "Other Reserves" The details of the utilisation of Share Premium Account should be clearly disclosed in the year of utilisation The word "Fund" should be attached with any reserve provided it is clearly represented by the ear-marked investments in that connection

(*b*) *Expenditures incurred in respect of salaries and perquisites of employees of the company* This has to be shown by way of note in the profit and loss account as required according to the Note (2) under clause 3 (x) (f) of Part II of Schedule VI The break up of total expenditure of the company on (a) salary, wages and bonus and (b) contribution to provident and other funds should be disclosed separately in respect of—

(i) employees who are in the employment of the company for the whole year covered by the profit and loss account and earned individually a minimum of Rs 36,000 as total remuneration for the year, and

(ii) those employees who were employed for part of the year and individually earned at a rate not less than Rs 3,000 per month

The related number of employees falling in each category is also required to be disclosed It may be noted that the term "remuneration" includes honoraria, perquisites, valued on the basis of Income-tax Act and Rules made thereunder

42 Distinguish clearly between:

(*a*) free reserves and specific reserves, and

(*b*) contingent liability and future liability

Difference between free reserve and a specific reserve A free reserve is not tied to any specific purpose and can be freely used for any general purpose at the discretion of the directors of the company. On the other hand, the specific reserve, in general, can be used for the purpose for which it is created Both the reserves are created from the appropriation of the profits and represent undistributed profits The main point of difference lies in their objects with which they are created The general reserve may be used for any purpose at the discretion of the directors and can be used for the payment of dividends to the shareholders of the company. The specific reserve is created with specific purpose and is normally used for the purpose for which it is created For instance, the dividend equalisation fund is created for the purpose of equalisation of dividend in the event of the inadequacy of the profits and, therefore, is used mainly for the purpose However, under exceptional circumstances, the specific reserves may also be used, at the discretion of the directors of the company, for the purpose other than for which they are created For instance, a reserve created for the redemption of the debentures may also be utilised for the payments of dividends, if the directors so decide However, it may be noted that the specific reserve created for the redemption of the debentures under the Debenture Trust Deed cannot be used for any other purpose Thus, in general, the free reserve can be used for any general purpose whereas the specific reserve can be used for any specific purpose.

Difference between the contingent liability and a future liability A contingent liability is one which may or may not become a liability at a future date depending upon the happening of certain event Thus, a contingent liability is a future liability whereas a future liability need not be contingent liability For instance, a contingent liability in respect of damages, for which the case is pending in the court of law, is not a future liability It is because it would become a liability only when the court gives the judgment against the company Otherwise it will not be a liability for the

company at all Such uncertainty regarding liability does not exist in case of a future liability A future liability is a real liability It is an accruing liability which has to be paid by the company at a future date and there is no uncertainty in this respect For instance, if a company is under legal obligation to pay gratuity, it is a future liability and has to be paid at a future date

43 Discuss the duties of an auditor, if he finds during the course of audit the existence of secret reserve in a company

The creation of secret reserves by a company is now prohibited by the Companies Act, 1956 Thus, if an auditor finds the existence of secret reserves in case of a company, he must bring this fact to the notice of the shareholders in clear words

But in case of banking and insurance companies, creation of secret reserve is not prohibited An auditor of a banking or insurance company, thus, should not qualify his report because of the existence of such reserves On the other hand, he should enquire into the necessity of creating it and if he finds that the intention of its creation is quite honest and it has been done in the larger interest of the company, and also that the amount with which it has been created is reasonable, he should pass it without making any report to the members of such company.

44 What is the difference in principle between the audit of the accounts of a private firm and that of a limited company ?

The following are the main points of difference between the audit of accounts a firm and that of a limited company

(*i*) The audit of accounts of a firm is voluntary and not required under any statute, but in case of a company it is legally compulsory

(*ii*) The appointment of auditor of a firm is made by the agreement between the partners, but in case of a company he is appointed under the statute, generally by its members

(*iii*) Rights and duties of a firm's auditor are decided by the partners, put in case of a company they are statutory

(*iv*) Duties of a firm's auditor may be subject to modification or limitation, but a company auditor's duties cannot be limited, though they may be extended

(*v*) The Partnership Deed of a firm may be written or oral and may not be shown to an auditor, but a company auditor must know the contents of the Memorandum and Articles of the company For *ultra vires* acts, he may be held responsible

(*vi*) An auditor of a firm reports according to the terms of his appointment but in case of a company, he has to report according to the provisions contained in the Companies Act

(*vii*) Liability of an auditor of a firm is contractual and no question of a criminal liability arises, but a company auditor is liable not only under common law but under the statute also In case of a firm he may contract himself out of liability but a company auditor

cannot exonerate himself from the liability contained in the Articles etc

45 During the course of audit of a company you find that it has adopted Table A for its day to day regulation and does not have any articles of Association To what particular provisions of the Table you would mainly refer ?

As auditors of company we are mainly concerned with the following provisions of Table A

(*i*) The directors may make calls upon the members in respect of any moneys unpaid on shares, but no calls shall exceed one-fourth of the nominal amount of a share or be payable at less that one month from the call (Regulation 13)

(*ii*) Interest at 5% per annum shall be charged on all unpaid calls from the day appointed for the payment thereof to the time of the actual payment but the directors may waive such interest wholly or in part (Regulation 16)

(*iii*) The directors may accept calls in advance and may allow interest thereon at such rate (not exceeding without the sanction of the company in general meeting 6% per annum) as may be agreed upon between the member paying the sum in advance and the directors (Regulation 18)

(*iv*) The directors may forfeit the shares of a defaulting member after giving him a notice requiring payment of the unpaid call A person whose shares are forfeited ceases to be a member of the company but he remains liable to pay the unpaid calls until the company receives full payment in respect of forfeited shares A forfeited share may be sold or otherwise disposed of by the directors, but before a sale or disposition, the forfeiture may be cancelled on such terms as the directors think fit (Regulations 29-35)

(*v*) The remuneration of the directors, if it consists of a monthly payment, is deemed to accrue from day to day In addition to remuneration payable to the directors in pursuance of section 309 the directors may be paid all travelling, hotel and other expenses properly incurred by them in attending meeting of directors or any committee or general meeting of the company or in connection with the business of the company (Regulation 65)

(*iv*) The company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the directors (Regulation 85)

(*vii*) The directors may from time to time pay to the members such interim dividends as appear to them justified by the profits of the company (Regulation 86)

(*viii*) The directors may, before recommending any dividend, set aside out of the company such sums as they think proper as a reserve or reserves which may be employed in the business of the company or invested outside (Regulation 87)

(*ix*) Subject to the rights of persons entitled to shares with special rights as to dividends, all dividends shall be declared and paid

according to the amounts paid on a share not being entitled to dividend (Regulation 88)

(x) A company in general meeting may, upon the recommendation of its board of directors, capitalise profits and reserves either by making the existing partly paid shares fully paid or by issuing bonus shares A share premium account and a capital redemption reserve account may also be similarly capitalised by issuing bonus shares but they cannot be capitalised by making existing partly-paid shares fully paid (Regulation 96)

46 As an auditor of a limited company, for what purposes you should refer to the following

(*a*) Articles of Association,

(*b*) Director's Minute Book, and

(*c*) Shareholder's Minute Book

(*d*) *Articles of Association* of a company contain provisions regulating its affairs As auditor we should refer to it for the following purposes

(*i*) Issue of share capital and rights of share-holders *inter se*.

(*ii*) Minimum subscription

(*iii*) Underwriting commission or brokerage

(*iv*) Rules for making calls on shares.

(*v*) Forfeiture of shares

(*vi*) Calls in advance and arrears and interest payable thereon.

(*vii*) Number, appointment, remuneration, borrowing powers etc on Directors, Managing Agents etc

(*viii*) Creation of reserves.

(*ix*) Accounts and audit thereof

(*x*) Payment of dividends

(*b*) *Directors' Minute Book* should be referred to for following purposes

(*i*) Allotment of shares and debentures

(*ii*) Calls made on them

(*iii*) Forfeiture of shares.

(*iv*) Adoption of contract with vendors

(*v*) Authorisation of capital expenses

(*vi*) Appointment and remuneration of Secretary, Managing Directors and other officers

(*vii*) Appointment of first auditors or in case of a casual vacancy and their remuneration

(*viii*) Resolution to make investments

(*ix*) Declaration of interim dividends

(*x*) Contracts in which particular Directors are interested

(*c*) *Shareholder's Minute Book* should be referred to for the following purposes

(i) Adoption of accounts

(ii) Declaration of dividends

(iii) Sanctioning appropriation of profits

(iv) Appointment and remuneration of auditors and directors

(v) Alteration of Articles, etc

47. State the various provisions of the Companies Act, 1956, under which an auditor may also be held liable as an officer of the company.

In general an auditor of a company is not its officer But under the Companies Act, 1956 he may also be deemed to be an officer and held liable as such The various sections under which he is also taken to be an officer are 477, 478, 539, 543, 545, 621, 625 and 633 These sections relate to—

(i) Power of the Court in winding up to summon persons suspected of having property of the company (section 477)

(ii) Court's power to order public examination of persons guilty of frauds etc in the promotion, formation or management of the company (section 478)

(iii) Falsification of books and penalty therefor (section 539)

(iv) Court's power to assess damages against delinquent officers (section 543).

(v) Prosecution of delinquent officers and members (section 545)

(vi) Cognizance of offences (section 621)

(vii) Payment of compensation in cases of frivolous or vexatious prosecution (section 625)

(viii) Power of court to grant relief in certain cases (section 633)

48 Discuss the transactions of the company which require sanction from the Court

The following transactions of a company require the sanction, confirmation or order of the Court before they would be valid

(i) Issue of shares at a discount (Section 79)

(ii) Reduction of share capital (Section 101)

(iii) Purchase of its own shares by a company and the consequent reduction of capital (Section 402)

49. A company purchased some fixed assets and in consideration for that issued to the vendor fully paid shares in the company It did dot enter into any agreement with the vendor and its records are found in the Director's Minute Book only Discuss the statutory requirements in this connection

The statutory requirements in connection with the allotment of shares by a company are contained in Section 75 of the Companies Act, 1956 Under this Section, every company must file a return of allotment of shares within one month thereafter It should state the

number and nominal amount of the shares comprised in the allotment, the names, addresses and occupation of the allottees, and the amount, if any, paid or due and payable on each share

In case the shares have been issued for consideration other than cash, as in the present case, a contract in writing should be produced before the Registrar But if there is no contract as given in the question, the company shall, within one month after the allotment, file with the Registrar the prescribed particulars of the contract stamped with the same stamp duty as would have been payable if the contract had been reduced to writing These particulars would be deemed to be an instrument within the meaning of the Indian Stamp Act, 1899 Together with this, a return stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up and the consideration for which they have been allotted should be filed with the Registrar

50 The share capital of a Company consists of 10,000 shares of Rs 100 each A Prospectus has been issued for 2,000 shares and there is no mention of any minimum subscription Applications have been received for 1,876 shares and application money at the rate of Rs 4 per share has also been received Directors proceed with allotment of shares

Will the allotment be regular ? If not, explain the points of irregularity

In the given circumstances the allotment made by the directors of the company would not be regular Under Section 69 of the companies Act, 1956, no allotment shall be made of any share capital of a company offered to the public for subscription unless the following conditions are fulfilled

(*i*) The amount stated in the Prospectus as the Minimum Subscription (to be reckoned exclusively of any amount payable otherwise than in money) has been subscribed

(*ii*) The sum payable on application in respect thereof has been received by the company

(*iii*) The amount payable on application on each share must not be less than five per cent of the nominal amount of the share

(*iv*) All moneys received from applicants for shares must be deposited in a scheduled bank until the certificate to commence business is obtained or they are returned in accordance with the provision of Section 69 (5)

As the provisions in clauses (*i*), (*iii*), and (*iv*) given above have not been satisfied, the allotment would be irregular

51 A company has made an issue of secured debentures

(*a*) What are the documents which the company's auditor should examine in order to ensure that all requirements

of law connected with the issue have been complied with?

(*b*) If the debentures have been issued at a discount, may the discount be written off over the entire period of currency of the debentures (twenty years)?

(*c*) If the debentures have been issued at a premium, can the premium be credited to the Profit and Loss Account and distributed as dividend?

(*a*) To ensure the compliance of requirements of law connected with the issue of debentures, the auditor should examine the following documents

(*i*) Consent of the Central Government obtained if he aggregate of the company's capital issue (both shares and debentures) during the year is in excess of Rs 25 lakhs

(*ii*) Resolution authorising the issue of debentures

(*iii*) The Prospectus, if issued to the public

(*iv*) A certificate of registration

(*v*) Register of charges

(*vi*) Register of Debenture-holders

(*vii*) Copy of return of allotment

(*b*) The discount on issue of debentures may be written off over the period of currency of the debentures, *i e* twenty years, and there is no law against it Spicer and Pegler are of the view that it would not be incorrect "to write off the discount over the term of debentures" But as a matter of financial soundness, it should be written off as early as possible since it does not represent any value

(*e*) The premiums received on issue of debentures are not the profits of the company in the ordinary course of business and should be treated as capital profits These are not available for distribution as dividend to the shareholders However, the Companies Act does not prescribe the manner of their utilisation

52 A company issued a Prospectus stating therein that application for permission for the shares offered to be dealt in on a recognised stock exchange is being made Discuss the effects if (*i*) the company did not apply for permission, or (*ii*) the company applied but the permission was not granted

If a company states in its Propectus that application for permission for the shares offered to be dealt in on a recognised stock exchange is being made, it must apply for such permission within ten days of its issue If it is not done, any allotment made by the directors would be void It will be void even if the application is made but the permission is not granted within four weeks from the date of closing of subscription list (Section 73)

In both the cases, the company will have to repay without interest all the moneys received from the applicants of its shares within eight days In case it is not done, the directors of the company shall be jointly and severally liable to repay the same But they will have

to pay interest also at the rate of 5 per cent per annum from the expiry of the eighth day

It is to be noted that any condition purporting to require or bind any applicant for shares to waive such effects, as given above, shall be void

53 Can a company pay interest out of capital legally? If so, mention the various conditions under which it can do so

In general, a company cannot pay interest out of its capital It is only when a company has been formed to undertake some construction or other related work and would not be able to earn sufficient profit for some years that it can legally pay interest on the paid-up capital (Section 208) Besides, a company can do so under the following conditions only —

(*i*) It should be authorised by the Articles of the company or by a special resolution

(*ii*) Previous sanction from the Central Government should be obtained

(*iii*) Payment of interest should be made upto a period determined by the Central Government

(*iv*) The rate of interest should not exceed 4 per cent per annum or any other rate as notified by the Central Government

(*v*) It should not operate as a reduction of the amount paid up on the shares in respect of which it is paid

54 While auditing the accounts of a limited company, you find that it has issued shares at discount State under what circumstances you would pass it

If as auditor you find that the company has issued shares at a discount, you may pass it if you are satisfied that the following conditions of Section 100 of the Companies Act, 1956 have been fulfilled

(*i*) At least one year has elapsed since the company was entitled to commence business

(*ii*) A resolution for this has been passed in the General Meeting of the Company specifying the maximum rate of discount

(*iii*) It has been sanctioned by the Court

(*iv*) Shares have been issued within two months of the sanction of the Court

(*v*) The rate of discount has not exceeded 10 per cent

(*vi*) Particulars of discount allowed are clearly mentioned in the Balance Sheet till they are written off

55 A limited liability manufacturing company has made considerable additions to its workshop building Sufficient cash not having been available, additional funds required have been borrowed from the company's Bankers and interest has been paid on the loan The directors desire that the amount of interest paid during the period of construction should be charged to the Building Account as it was not

an expense incurred in the ordinary course of business

As an auditor, what would be your opinion in this matter

The directors may charge the interest to the Building Account as part of the cost of the buildings under section 208 provided the shares are issued for the purpose of raising money for the construction of the buildings which cannot be made profitable for a long period But it may be charged only when certain prescribed conditions are fulfilled

The company could have also charged it to the Building Account provided it had raised the money by the issue of debentures as decided in *Hinds v Buenos Ayres Grand National Tramway Co Ltd* (1906)

In the present case, the loans have been taken from the bankers of the company and neither shares nor debentures have been issued for the purpose Therefore, the interest paid on such loans cannot be capitalised and charged the Building Account as desired by the directors

56 An engineering company reconstructed part of its own offices utilising old materials partly in the new construction Additional materials have been purchased or issued from the stores The supervision of the construction has been carried on by the company's own staff.

How would you proceed as an auditor to scrutinise the capitalised cost of the new building ?

The steps which have to be taken to check the capitalised cost of the new building would be as follows

(*i*) To examine that the amount of the old materials utilised in the construction has been debited to the new building account and at the same time credited to the old building account The balance of the old building account should be charged to revenue

(*ii*) To vouch the expenditures on the new building in respect of labour and material with related and available vouchers

(*iii*) To see that the overhead charges connected with the cost of supervision are not abnormally high and are reasonable

(*iv*) To find out whether any profit has been taken into account, assuming that the cost of the construction would have been higher if done by an outside contractor If so, ascertain that only reasonable amount has been taken into account and that the profits so accounted have not been distributed to the shareholders by way of dividend as it would amount to the return of capital to them which is illegal. Such profits will not be trading profits earned in the ordinary course of business and in fact they would never be realised

57 While auditing accounts of a limited company, an auditor comes across the following matters State how would he deal with them .

(*a*) The directors hand over to him a list of the work they want him to do or carry out and state that it is not necessary for him to do anything outside the list

(*b*) The minute Book is in the form a loose leaf book , the Chairman signs the last page of the minute of each meeting

(*c*) The Articles provide that any voucher signed by any two directors shall be evidence of payment chargeable against the company and shall be accepted by the auditor as such

(*d*) The Managing Agents have sold some forfeited shares by private negotiation of a person who is the partner of a Director in some other business firm

(*a*) If the directors of the company delimit the work of an auditor, he should not accept it if such restrictions would not enable him to perform his statutory duties An auditor's duties are expressly laid down in the Companies Act, 1956 and the directors cannot reduce them, although they may further extend them (*Newton v The Birmingham Small Arms Co Ltd* 1906)

(*b*) The auditor should not approve the arrangement of keeping the Minute Book in the form of a loose-leaf Book It is because there are possibilities of substitution of old leaves by new ones with certain changes Anyhow, if the Minute Book is maintained in such form, he should insist that the Chairman should sign "each page Under section 193 (1-A) also it has been clearly stated that each page of every such book shall be initialled or signed and the last page of the record of proceedings of each meeting in such book shall be dated and signed"

(*c*) Any provision in the Articles of a company restricting the rights and duties of an auditor is void The restriction that the auditor shall accept the vouchers signed by two Directors in connection with the payments chargeable against the company shall, therefore, not be binding on him If the auditor feels the necessity of getting more information with regard to such payments, he can legally obtain them

(*d*) A managing agent has no authority to sell or allot the forfeited shares The forfeited shares may be sold or otherwise disposed of on such terms and in such manner as the Directors think proper. Thus, it is the power of Directors and not of a Managing Agent to sell the forfeited shares Therefore, the auditor should raise objections to such sale of forfeited shares by the Managing Agents.

58 As auditors of a limited company, you find that its Managing Agents have kept a few lakhs of rupees as cash in hand When you questioned the managing agents' action, they stated—(*a*) the present amount of cash is not within the purview of audit, and (*b*) this is a matter of policy and the auditor should not question this

What is your duty ?

(*a*) The Managing Agents cannot take the plea that the amount of cash is not within the purview of audit Verification of cash-in-hand is essential and we should not be negligent in this respect without running a serious risk of being held liable for it without being satisfied about this important asset, we cannot be in a position to perform the statutory duties and report as regards the true and fair financial state of affairs of the concern In view of this, we have got every right to seek information with regard to cash-in-hand and the Managing Agents cannot deny it It they do so, we must report the fact to the shareholders of the company

(*b*) With regard to the policy of the Managing Agents maintaining a few lakhs of rupees as cash-in-hand, they may do so if they deem it proper in the interest of the company We have nothing to do with the business policy of the managing agents as long as we are satisfied that the specified cash exists and maintenance of huge cash balance is not being done with some dishonest motive

59 Mention the special points to which an auditor of a company should give attention the following cases

(*a*) Purchase of shares of a company under the management of the company's own managing agents.

(*b*) Loan by a company to its shareholders to enable them to purchase the company's own shares.

(*c*) Sale of the undertaking of the company

(*d*) The total amount of the provident fund kept by the company and invested in the shares of a subsidiary company

(*a*) In connection with such purchases of shares by the company the auditor should be guided by the provisions of section 372 of the Companies Act, 1956 This section imposes restrictions on the purchase of shares of a company in the same group The auditor should see that the requirements of the section have been duly complied with

(*b*) The auditor should note that under Section 77 (2) no company can give loan to anyone to enable him to purchase the company's shares unless certain conditions given therein are fulfilled It can do so in the following circumstances

(*i*) Where a banking company lends money in the ordinary course of business

(*ii*) Where a loan is made in connection with an employee's profit-sharing scheme

(*iii*) Where a loan is made by a company to its employee's other than directors, managing agents, secretaries and treasurers or managers, to enable them to purchase fully-paid shares But the amount of loans shall not exceed the six-months salary or wages.

(c) The auditor should note that the sale of the undertaking of the company cannot be undertaken unless the consent of the company in the general meeting is taken as provided in section 293 The management cannot also invest the sale-proceeds of the property of the company except in the trust securities

(d) The auditor should point out that it is wrong to keep the total amount of the provident fund with the company itself and invest it in the shares of its subsidiary company Under section 418 of the Companies Act, 1956, the company should keep such monies deposited (i) in a post office savings bank account, or (ii) in a special account to be opened by the company for the purpose in the State Bank of India or in a scheduled bank or (iii) where the company itself is a scheduled bank, in a special account to be opened by the company for the purpose either with itself or with the State Bank of India or in any other scheduled bank It may also invest the monies in the specified securities only

Thus, the auditor should report that such action on the part of the company is in contravention of the provisions of the Act

60 How would an auditor of a limited company deal in the following circumstances

(a) Payment of Rs 5,000 has been made to each of the directors as allowance to cover travelling and entertaining expenses

(b) At a meeting when a proposal to buy another business for cash was approved and subsequently carried out, it was later on found that there was no quorum

(c) A relative of a director has been appointed as Secretary of the company on a remuneration of Rs 2,000 per month

(d) Freehold building of the company has been completely written off and now omitted from the Balance Sheet

(a) With regard to the payment of Rs 5,000 to each of the directors as an allowance to cover travelling and entertaining expenses, the auditor should refer to the Articles of the company to see that such payment is duly authorised by it If Table A applies to the company, it is authorised under clause 65 (2) He should then vouch it with the help of the receipts from the directors He should satisfy himself that the expenses are reasonable

(b) The auditor in this case has simply to see that the transaction is in order and he has nothing to do whether there was quorum or not If he is satisfied with the records in the Minute Book, he may assume that the meeting was validly held

(c) The auditor should see that appointment of a relative of the director as a Secretary of the company is duly sanctioned by a

special resolution of the company Such sanction is required because the salary exceeds Rs 500 per month He should also see that the company has filed a copy of the resolution with the Registrar within thirty days of its passing

(*d*) The auditor should advise that it is not a right policy to write off any fixed asset completely and not to show it in the Balance Sheet until it is discarded It has the grave danger of being lost sight of There is a possibility of its being sold off and the monies misappropriated The auditor himself may not be able to detect it He should suggest that excess depreciation charged in the past should be restored by writing up the Buildings Account and crediting the Depreciation Reserve Account by that amount.

61 While auditing accounts of a limited company, you find the following items in its Balance Sheet

(*a*) Motor Vehicles on hire-purchase		
Instalments paid	Rs 10,000	Rs
Less Depreciation 20%	2,000	8,000
(*b*) Loans by Directors and Bank overdrafts		50,000

You are required to state—

(*i*) how as auditor you would verify the above items , and

(*ii*) what changes you would suggest in their presentation in the Balance Sheet

(*a*) As auditor, we should verify the existence of Motor Vehicles on hire-purchase by actually inspecting them With regard to their valuation we should find out the cash value of the vehicles and seek expert opinion with regard to the percentage by which such depreciation should be charged

It is completely wrong to present the accounts in the manner given in the question.

Assuming that the total cash value of the motor vehicles is Rs 30,000 and that out of this Rs 10,000 are paid by way of instalment, Rs 500 has been paid by way of interest and that the rate of depreciation (i e 20%) is reasonable, they should be presented as folllows —

	Rs	Rs.
Motor Vehicles—		
Hire purchase instalments paid upto date	9,500	
Less Depreciation @ 20% on Rs 30,000	6,000	3,500

(*b*) To verify loans by the Directors and Bank overdrafts, we should see the agreement with the Directors and obtain a certificate from the Bank We should ascertain whether loans are secured or unsecured We should also see whether the interests due on them have been duly paid or not

With regard to the presentation of loans in the Balance Sheet, Secured Loans and Unsecured Loans should be shown separately. Loans from Directors should also be shown separately Assuming

that the loans are secured and loans from Directors are Rs 20,000, they should be shown in the Balance Sheet as follows

	Rs
Loans and advances from Bank	30,000
Loans from Directors	20,000

62 **How would an auditor deal with the utilisation of Premiums on the issue of Shares and Debentures by transferring them to—**

(*a*) Profit and Loss Account;

(*b*) Reserve Fund, or

(*c*) Goodwill Account

Premiums received on issue of Shares or Debentures are not gains in the ordinary course of business of a company Keeping this in mind, the auditor should proceed in each case as follows

(*a*) He should have no objection to the transfer of premiums on the issue of shares or debentures to the Profit and Loss Account provided the Articles of Association of the company do not contain anything contrary If the management of the company so decide, they may distribute the proceeds to the shareholders by way of dividends But financial prudence demands that such gains which are of non-recurring nature and do not arise in the ordinary course of business should not be included in the normal trading profits of the year

(*b*) Such premiums may be transferred to Reserve Fund and the auditor should have no objection to it But as the Reserve Funds may be utilised for the equalisation of dividends, they may be utilised for payment of dividends to the shareholders Though legally not prohibited, it should not be done from the point of financial soundness of the company

(*c*) The auditor should welcome such a step and should raise no objection if such premiums are transferred to Goodwill Account. It would result into writing down the value of Goodwill, which is financially quite desirable Goodwill is an asset of intangible nature and should not be allowed to stay in the accounts for long and be written off as early as possible

63 **During the course of audit of a company an auditor finds that—**

(*a*) The Register of Members has not been written up and, therefore, it is not possible to agree the balances thereon with the issued share capital , and

(*b*) The Sales and Purchases Ledger are not balanced properly and material difference remains on the control account of each Ledger, which difference it has been proved impossible to trace by the time the audited accounts must be completed and submitted

How would he proceed under such circumstances ?

(*a*) If it is found by the auditor that the Register of Members has not been written up and because of that it is not possible for him to check that the total of the shares issued agrees with the issued share capital or in case of a new issue the cash received and the shares allotted agree, he should require it to be fully written before the audit work is completed It is to be noted that the Register of Members is a statutory book which every company must keep Any omission to maintain it would make the officers concerned liable If the auditor finds that inspite of his suggestion the Register has not been duly written up, he must mention the fact in his report

(*b*) If it is found that there is a material difference on the control account of each Ledger, the auditor cannot submit his report stating that the Balance Sheet and the Profit and Loss Account show a true and fair state of affairs of the company In view of this, he should require the difference to be carried to a suspense account The suspense account should be shown clearly and separately in the Balance Sheet The auditor should also mention this fact in clear words in his report

64 In course of audit of a company it is found that its Manager is entitled to a commission of 25% of the net profits of the company. How would an auditor deal with it?

The auditor should take the following steps to verify the commission payable to the Manager of the company

(*i*) Ascertain that the salary and commission taken together do not exceed 5% of the net profits of the company calculated in the prescribed manner (section 387) In case it exceeds 5%, find out that prior permission from the Central Government has been taken in this respect

(*ii*) Check that the commission payable to the Manager along with the remuneration of other managerial personnel is within the limits prescribed under the Act The total managerial remuneration must not exceed 11% of the net profits of the company (section 198)

(*iii*) See the provisions of the Articles of the company in this respect and check that those have already been taken into account

(*iv*) Ask for the agreement with the Manager and check that the terms and conditions therein have been duly observed

(*v*) See that the profits of the company have been calculated in accordance with the prescribed provisions of the Act

(*vi*) Vouch the commission paid to him carefully with reference to the salary book and the receipt from the Manager

65 The Auditor of a Limited Company objects to the form in which it is proposed to present the Accounts of the company to the shareholders What steps should he take ?

It should be noted that the form and presentation of Accounts of a company should be made according to the provisions of the Companies Act, 19 6 If the auditor feels that the form in which the company proposes to present the Accounts to the shareholders has

not been prepared according to the statutory requirements or in the manner in which the auditor feels necessary, he should discuss the matter with the directors and make his suggestions in this respect He should persuade them to make necessary alterations in it If the directors agree to his wishes, he has nothing to say In case they do not amend the accounts in the form which he can approve, he should refer the matter in his report in clear words But he cannot alter the form of accounts as desired by him The Accounts are directors' production and an auditor has no control over them The only course open to him is to report the matter to the shareholders

66 What information relating to the fixed assets of a company is required by law to be disclosed in its Balance Sheet ?

Under the Companies Act, 1956, the following informations relating to the fixed assets of a company are required by law to be disclosed in its Balance Sheet

(*i*) The various fixed assets of the company would have to be shown separately In each case, the original cost, the additions thereto and deductions thereform made during the year should be given. The depreciations provided on them must be given Where the original cost cannot be ascertained, the book value of the asset may be given in its place

(*ii*) Where any sums have been written off assets or a reduction of capital or a revaluation of assets, each Balance Sheet for the five years after the date of reduction, must also state the amount of reduction and the date of reduction, but the Balance Sheets prepared after the five-year period need not state the amount of reduction. Similarly, where any sums have been added by writing up the fixed assets, it should be given

(*iii*) If on the date of the Balance Sheet, there is any capital expenditure which cannot be allotted to different fixed assets, such expenditure is shown as Capital Work-in-Progress or Unallotted Capital Expenditure.

(*iv*) The amount of depreciation applicable to items sold or discarded during the year should be deducted from the total depreciation provided in respect of the relevant fixed asset up to the beginning of the year.

67. What is the information required to be given in a Profit and Loss Account of by way of a note therein in connection with payments made to or provided for the directors, managing agents, secretaries and treasurers or manager, if any, by a company ?

The Profit and Loss account of a company must contain detailed information either in itself or by way of a note therein, the following payments provided or made during the financial year to the directors, managing agents, secretaries and treasurers or manager, if any

(*i*) Managerial remuneration under Section 198

(*ii*) Expenses reimbursed to the managing agent under Section 354

(*iii*) Commission or remuneration payable to the managing agent or his associate separately under Section 356, 357 and 358

(*iv*) Commission received or receivable under Section 359 by the managing agent or his associate

(*v*) Money value of contracts entered into by the company with the managing agent or his associate under Section 360

(*vi*) Other allowance of commission (including guarantee commission) giving details thereof

(*vii*) Any other perquisities or benefits in cash or in kind stating approximately their money value where practicable

(*viii*) Pensions, gratuities, payments from provident funds in excess of own contributions and interest thereon, compensation for loss of office or in connection with retirement from office

It should also contain a statement, or give by way of note a statement showing the computation of net profits in accordance with Section 349 giving relevant details in connection with the calculation of commission payable by way of percentage of net profits to the directors, managing agents, secretaries and treasurers or manager.

68 In a manufacturing concern, although sales have improved as compared to the previous year, there is a considerable fall in the trading profits What can be the causes for such decrease ? Discuss the duties of an auditor in this connection.

The causes for the decline in trading profits inspite of considerable volume of sales as compared to the previous year may be as follows .

(*i*) There might have been fall in the prices of commodity sold and, therefore, proportional reduction in the profit The amount of sales may remain the same as in the previous year because in the current year the quantity of goods sold might have increased

(*ii*) The prices at which the raw material might have been purchased would have gone up so that inspite of increase in the sales the profits might not have increased

(*iii*) The manufacturing and other expenses might have increased during the year which may reduce the profits.

(*iv*) The closing stocks might have been under valued or they might have been valued at market price which would be lower than the cost Some of the items which ought to have been included in the stock might not have been done so or some of the stock might have been misappropriated Thus, a reduction in the amount of stock would reduce the profits

(*v*) Some errors of omission might have crept in because of which certain goods sold might not have been recorded in the books at all

Auditor's duties In this connection, the auditor should proceed as follows :

(*i*) Enquire about the internal check and see whether there is any chance for the misappropriation of goods or inclusion of dummy

workers in the wages sheets etc

(*ii*) Ascertain the total quantity of goods sold with reference to Stock Ledger.

(*iii*) Examine the invoices to find out any increase in the price of raw materials etc

(*iv*) Check increase in the manufacturing cost, examine the related bills regarding carriages, freight, water and electricity charges etc

(*v*) Compare Wages Sheets of current and previous years to ascertain increase in the wages of workers

(*vi*) Verify stock carefully and exhaustively and see whether all the items which ought to have been included it has been duly included

(*vii*) Check whether the market price is lower and compare the cost of materials with the market quotations

(*viii*) Enquire whether price of commodities sold has fallen as compared to previous year and check it with the help of stock sheet of current as well as previous years

(*ix*) Examine the books of original entry or Sales Book and Cash Book thoroughly to ascertain that there is no omission of sales in the Books

69 An auditor finds that the Profit and Loss Account of a company shows sufficient amount of profits and the directors have declared the dividends on that basis But the directors do not pay dividends for want of sufficient cash balance Discuss the duties of an auditor under such circumstances

The auditor should first try to satisfy himself with regard to the correctness of the Profits shown by the Profit and Loss Account There may be a possibility of profits being inflated To check this he should check whether—

(*i*) the stock has been inflated either by including in it fixed assets or other items not to be included in it or by its overvaluation,

(*ii*) the purchases have been suppressed or the sales have been inflated ,

(*iii*) the provisions for depreciation or other necessary reserves have either been not made or insufficiently made

(*iv*) the revenue expenses have been charged to capital or capital receipts have been recorded as revenue receipts ;

(*v*) the outstanding expenses have not been included, and

(*vi*) liabilities have either been omitted or under-valued.

If, on enquiry, he finds that the profits shown are not correct on account of one or more of the above reasons, he must insist for the necessary alteration in the accounts If it is not done, he must report the fact to the shareholders of the company

In case the auditor finds that profits have been correctly ascertained he should enquire the reason for the insufficiency of cash balance It may be because of the following reasons

(*i*) Cash may be locked up in book debts and stock-in-trade etc

(*ii*) Some fixed assets might have been purchased

(*iii*) Some capital expenses might have been incurred with a view to make permanent improvement of the assets, say, plant and machinery

If cash is thus locked up and profits have been correctly ascertained, the auditor should make suggestion, if called for, to arrange for cash so that dividends may be paid It is to be noted that the dividends must be paid within 42 days from the date of declaration (section 207)

70 As auditor of a Limited Company you find that, during the last week of the period under review, it has resorted to heavy sales of finished stock with a view to pay dividends to the shareholders Discuss its effects upon the rate of dividends What circumstances would justify such a sale ?

The effect of the sale of the large part of the finished stock at the end of the year may or may not affect the rate of dividends payable to the shareholders It would depend upon the extent of the profits made on such sale

It will have no effect on the rate of dividends if the sale has been resorted to at the cost of manufacture simply to dispose off the stock It will simply result in conversion of stock into cash if cash sale has been made, and into debtors if credit sale has been made Such sale would not be justified if profit is expected at some future date but it may justified if it is anticipated that there is going to be a fall in the price of the stock-in trade

The rate of dividend will be affected if the stock is sold at profit as it would increase the amount of profit available for dividend Suct transactions, however, may not be justified if the profits earned on them are lower than what would have been obtained if the sale would have taken place later and slowly

The company should resort to the huge sale of the finished stock provided it is able to earn sufficient and usual profit But if it is not able to earn sufficient profits on such sale it would be advisable to obtain loans so as to enable it to pay dividends if it is facing the difficulty of ready cash for the payment of dividends to the shareholders

71 A company used to write down some of its assets excessively out of profits In the current year, it wants to write them up and credit such excess to Profit and Loss Account with a view to pay dividends out of it Discuss whether the company can do so

If a company has written down some of its assets excessively out of profits in the past, it may legally write up those assets and credit the amount to Profit and Loss Account It can legally distribute dividends out of such excess so written up, because withholding a part of profits in the past does not amount to its capitalisation and the company may utilise such withheld profits. But the company can do so if the following two conditions are fulfilled

(*i*) The amount by which the Profit and Loss Account is credited should not be more than the excess profits withheld in past by writing down assets excessively, and

(*ii*) those assets are not shown in excess of their present true value to the business concerned

In *Stapley Reed Brothers Ltd* (1924) it was held that the writing off of the Goodwil out of profits in previous years does not amount to permanent capitalisation of such profits and the company was not precluded, in any subsequent year, from writing back to Goodwill Account, a sum not exceeding its then fair value, by crediting Profit and Loss Account and treating such profit available for dividends

72 Would you as an auditor of a company approve the payment of dividend out of the profits arising from the sale of fixed assets of the company ?

Profits which arise from the sale of fixed assets of a company are not of routine nature and trading profits They are, in fact, capital profits As auditor we should not ordinarily approve payment of dividends out of capital profits, unless the following conditions are fulfilled ·

(*i*) The company's Articles of Association do not prohibit such payments,

(*ii*) The surplus must have been realised , and

(*iii*) Such suplus remains even after a proper revaluation of other assets of the company

73 Discuss the responsibility of an auditor in case the Balance Sheet of a company signed by him is not placed before the Shareholders at the annual general meeting

An auditor's duty is over after he has signed the Balance Sheet and his report and submits them to the Secretary of the company The auditor is not at all responsible for the publication and sending of the Balance Sheet together with the auditor's report to the members of the company Such responsibility has to be shouldered by the directors of the company.

Such problem arose in case of *Allen, Craig and Company Limited* (1934) and it was held that the duty of the auditor was discharged

when he affixed his signature to the report attached to the Balance Sheet and forwarded it to the Secretary of the company

74 On revaluation of land and Buildings (book-value Rs. 50,000) the directors find that their value has increased to Rs 75,000 They decide to transfer excess value (Rs 25,000) thus ascertained to the credit of the Profit and Loss Account How would an auditor deal with it ?

The auditor should first enquire the reason why the value of Land and Building has increased If he finds that this increase of Rs 25,000 in their value is on account of rise in their market value, he should object to transfer of such unrealised profits on them to the credit of Profit and Loss Account It would amount to distribution of a capital profit which has not been realised at all He should persuade the directors not to do so and if they do not accede to his requests, he must report the matter to the shareholders in clear words

On the other hand, if he finds that this increase in value of Land and Buildings is a result of excessive depreciation having been charged on them in the past, he should have no objection to such step being taken by the directors Such step would simply amount to proper adjustment in the value of Land and Buildings Account It would set right more than necessary depreciation having been provided in the past It was held in *The Ammonia Soda Co Ltd v Arthur Chamberlin and Others* (1918) that a company may write up the value of its assets as a result of bonafide valuation and may distribute current profits without first making good past losses

75 There is a very large accumulation in the Unclaimed Dividends Account of a company The Directors want to transfer this to the Profit and Loss Account for re distribution as dividend

Discuss the soundness of this proposal from the (*i*) legal and (*ii*) financial points of view

The unclaimed dividends constitute a debt and legally the company cannot utilise it unless it is statute barred Under Article 120 of the First Schedule to the Indian Limitation Act, 1908, it does not become statute barred for 6 years Therefore, the question of utilisation of the unclaimed dividends does not arise at all until it becomes time barred

Power may, however, be taken in the Articles of the company to forfeit the unclaimed dividends but this is not customary and usual practice If it is done so, the recognised Stock Exchanges will not grant an official quotation of the shares where the company has this power of forfeiture

From the financial point of view also it will be better if it is not utilised for the distribution of dividends but transferred to the reserves to enhance the financial strength of the concern It may be utilised for writing off the bad debts

76 The directors of a Limited Company governed by Table A proposed to the General Meeting a dividend at the rate of $7\frac{1}{2}\%$ per annum The shareholders being dissatisfied carried an amendment

declaring a dividend at the rate of 10% per annum and this was duly paid

If you were subsequently auditing the accounts of this company, what should be your attitude?

Clause 85 of the Table A provides that the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board In view of this and the general practice, the shareholders cannot increase the rate of dividends decided by the directors of the company It was held in *Bond* v *Barrow Haematite Steel Co* (1902) that the Court would be very reluctant to compel the directors to divide more than they thought proper, and the Courts will not compel a division of profits up to the hilt, as they regard it as perfectly proper and lawful for a company to carry forward a portion of the year's profits to the credit of the next year's Profit and Loss Account

Thus, the directors have got the absolute discretion as to the amount they may think proper for the distribution of dividends But in the present case, it appears that the directors yielded to the wishes of the shareholders and they allowed the increase in the rate of dividend from 7½% proposed by them to 10% as desired by the shareholders When the dividend has already been paid to the shareholders, as auditor we have nothing to do in this connection We have to see that the terms of the resolution of the directors or shareholders by which the dividend has been declared and satisfy ourselves that the dividend right attaching to each class of shares, as defined by Table A, has been duly complied with

77 Give in brief the main items of the Balance Sheet of a company as prescribed and in the order in which they should be shown therein Also state the details to be given in respect of contingent liabilities

In prescribed form of the Balance Sheet as given in Part I, Schedule VI to the Companies Act, 1956, the main items should appear in the order as follows

Liabilities	*Assets*
Share Capital	Fixed Assets
Reserves and Surplus	Investments
Secured Loans	Current Assets
Unsecured Loans	Loans and Advances
Current Liabilities	(*a*) Current Assets
and Provisions:	(*b*) Loans and Advances
(*a*) Current liabilities	Miscellaneous Expenditures
(*b*) Provisions	

Foot-note in respect of Contingent Liabilities should be given

The 'Contingent Liabilities' should not be included with other liabilities. Under its head, the various items should be classified as under .

(i) Claims against the company not acknowledged as debts.

(ii) The uncalled liability on shares partly paid.

(iii) Arrears of fixed cumulative dividends, with the following details

- (a) The period for which the dividends are in arrears, showing separately such arrears on each class of shares
- (b) The amount should be stated before deduction of income tax but in case of tax-free dividends the amount should be shown free of income tax and the fact that it is shown should be stated.

(iv) Estimated amount of contracts remaining to be executed on capital account and not provided for

(v) Other money in which the company is contingently liable, for example,

- (a) Liability on bills discounted not yet matured
- (b) Liability in respect of any suit pending in the Court against the company
- (c) Unsettled matter regarding bonus
- (d) Matter referred to Arbitration
- (e) Liabilities under a guarantee given

78. A clients want to purchase shares in a company whose Balance Sheet is given to you for criticism as follows Give your opinion in the form of a letter.

XY Co Ltd

LIABILITIES	Rs	ASSETS	Rs.
Shares Capital Rs 3,25,000 Less Calls unpaid 25,000	3,00,000	Plant & Machinery, Loose tools etc	80,000
		Sundry Debtors	75,000
Debentures and accrued interest thereon	50,000	Stock, work in progress and Raw Materials	25,000
Loans and interest	15,500	Investments, Loans and accrued Interest	85,000
Sundry Creditors	35,500	Freehold Property and Goodwill	94,000
Profit and Loss Account	9,000	Bills Receivables and cash in hand	51,000
	4,10,000		4,10,000

Dear Sir,

With reference to the Balance Sheet of XY Co Ltd , furnished by you for criticism and our opinion on the same, we would like to draw your attention that it does not contain various relevant informations and is too vague in its presentation of facts In view of this, an honest and useful opinion about the financial soundness of the company cannot be given without qualifications We draw your attention to the following facts

(i) Complete information with regard to the share capital is not available There should be details about the amount of authorised capital, number of shares, the face value of each share, number of shares on which the calls remains unpaid Thus, capital position of the company is not clear

(ii) With regard to debentures, the rate of interest payable on them should be mentioned Interest accrued thereon should be shown separately The period for which the interest is accrued is not clear Similarly, it is not possible to find whether they are charged or not , and if charged, whether it is fixed or floating charge

(iii) In case of loans and interests, the amount of interest should be given separately It is not clear about the nature of loans taken and securities provided from the facts given

(iv) Amount of Sundry creditors has been properly shown but the Profit and Loss Account balance needs some further information, specially the previous year's profit balance for comparison.

(v) So far as fixed assets are concerned, they have not been shown properly Freehold property and goodwill should be mentioned separately as goodwill is an intangible asset. Plant and machinery and loose tools should be shown separately. Amount of depreciation charged should be clearly mentioned but there is no information about it

(vi) The floating assets—stock, work in progress and raw materials—need description about the basis of valuation adopted in each case Investments, loans and accrued interest thereon should be disclosed separately About loans, there should be particulars as to whether they have been secured or not, bills receivables and cash in hand should also be given separately The amount of cash in hand need be disclosed clearly

It should be clear from the above facts that clear and complete picture is not available from the given Balance Sheet It is neither according to the form prescribed under the Companies Act, 1956, nor does it give facts clearly In view of this, we are unable to present the full criticism of the Balance Sheet and we shall be pleased to do the same if we get the required informations.

Yours faithfully,
AB
Chartered Accountants.

79 State the duties of an auditor in respect of provisions for taxation in case of a company audit

The auditor must check the provision for taxation made by the company very carefully since inadequate or excessive provisions for taxation would affect its final accounts considerably If the taxation liabilities are not correctly shown in the Balance Sheet of the company it would be misleading and would not show true and fair state of the financial affairs of the company which the auditor is required to report

The auditor should see that provision for different types of taxation has been adequately made for the whole of the tax of the current fiscal year At the same time, he must see that proper estimation of the taxation to be paid on the current year's profits assessable in the next year has also been made

While computing the tax liability of the company the following points should be taken into consideration

(*i*) Basis of accounting

(*ii*) Expenses not deductible under the Income Tax Act

(*iii*) Depreciation claim made

(*iv*) Development rebate claimed and the provision for the creation and maintenance of Development Rebate

(*v*) If the company is newly established, or profits have been received from the newly established undertakings, the relief given under the Act

(*vi*) Exemption from the super tax on the inter-company dividends

(*vii*) Carry forwards of the past losses and arrears of depreciation allowance

(*viii*) Tax deducted at source and tax recouped from dividends.

The auditor should see that such provision has been correctly shown in the Profit and Loss Account and the Balance Sheet as required under the Companies Act, 1956 He should see that the amount of charge for income tax and other taxes has been shown separately.

80. State the requirement of Schedule VI of the Companies Act, 1956 with regard to the disclosure of the following items in the balance sheet of a limited company

(*i*) Share Capital,

(*ii*) Loans and Advances,

(*iii*) Investments

(*i*) *Share Capital* The disclosure requirements of the Schedule VI of the Companies Act, 1956 are as follows

(*a*) Authorised share capital giving the number of shares and the nominal value of each share.

(*b*) Issued share capital distinguishing between the various classes of capital and stating the number of shares subscribed together with the nominal value and the amount called up for each share in respect of each class of capital

(*c*) Subscribed share capital distinguishing between the various classes of capital stating the number of shares subscribed together with the nominal value and the amount called up for each share in respect of each class of capital The number of shares allotted as fully paid up for a consideration other than cash and as bonus issue should be distinctly shown, deductions should be shown in respect of calls unpaid, separately by directors and others

(*d*) Amount originally paid up on any forfeited shares.

In addition to the above, following more information have to be given in this connection:

(*a*) Terms of redemption or conversion (if any) of the redeemable preference shares together with the earliest date of redemption or conversion,

(*b*) Particulars of any option on unissued share capital;

(*c*) If different classes of preference shares have been issued and subscribed for, the particulars thereof,

(*d*) Source from which the bonus shares have been issued, and

(*e*) In the case of subsidiary companies, the number of shares held separately by the holding company, ultimate holding company and its subsidiaries

(*ii*) *Loans and Advances.* The disclosure requirements in this connection are as follows

(*a*) Advances and Loans to subsidiaries

(*b*) Advances and Loans to partnership firms in which the company or any of its subsidiaries is a partner.

(*c*) Bills of exchange

(*d*) Advances recoverable in cash or in kind or for value to be received *e g* , Rates, Taxes, Insurance etc

(*e*) Balance with Customs, Port Trusts, etc

The following separate particulars of loans advances have also to be given·

(*a*) Advances and Loans considered good and fully secured

(*b*) Advances and Loans considered good for which the company holds no security other than advancee's personal security

(*c*) Advances and Loans considered doubtful or bad

(*d*) Advances and Loans due by directors or other officers of the company or any of them either severally or jointly with any other person or advances due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated.

(*e*) Advances and Loans due from other companies under the same management, within the meaning of sub-section (1B) of Section 370, to be disclosed with the names of the companies

(*f*) The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note

(*iii*) *Investments* The investment should be shown in the balance sheet distinguishing between

(*a*) Investments in Government or Trust securities

(*b*) Investments in shares, debentures or bonds showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies

(*c*) Investments in immovable properties.

(*d*) Investments in the capital of partnership firms and indicating their mode of valuation and nature

The Schedule also requires disclosure of the aggregate amount of the company's quoted investments together with the related market value and the aggregate amount of the company's unquoted investments It also requires that a statement of investments should be annexed to the balance sheet classifying trade investments and other investments

81 Discuss the circumstances in which a company can issue bonus shares What procedures have to be followed by it in this connection ? Also discuss the duties of an auditor in this regard

A company can issue bonus shares out of the accumulated or undistributed profits if the Board of Directors feel that it would be necessary to readjust the capital structure of the company in accordance with the real situation If there is huge amount accumulated as reserves, it adds to working capital of the company It increases earnings and rate of dividend but at the same time it becomes a cause of concern to the management It is because huge reserves attract the attention of the employees as well as customers of the company The employees start demanding more wages and allowances The customers desire a reduction in the price of the products of the company Thus, with the increase in the reserves and working capital, the earning capacity of the company also increases With this, the rate of dividends declared by the company also increases as

from year to year This attracts the investors or competitors and may persuade them to set up similar business With that, the competition may also increase Thus, accumulation of huge reserves creates problem and can be solved by issue of bonus shares which helps in readjusting the capital structure of the company with that of the real situation

Alongwith the undistributed profits and accumulated huge reserves, the credit balance in the share premium account and in the capital redemption reserve account may also be utilised by the Board of the company in issuing bonus shares to its shareholders

Procedure The directors will have to see whether the Articles of Association of the company enables them to declare the bonus shares or not In terms of Clause 96 of Table A of the Companies Act, 1956, a company can issue bonus shares in the general meeting, pursuant to a recommendation by the Board of Directors

If the Articles so permit, the prior approval will have to be taken from the Controller of Capital Issues Under the provisions of Capital Issues Control Act, 1947, read with the provisions of the Capital Issues (Exemption) Order, a company is required to obtain prior approval For this proper application has to be made to the Controller of Capital Issues in a prescribed form In this connection, Guidelines have already been issued by the Controller and the approval will be accorded to the company only when such guidelines have been duly followed For this, company may have also to submit a certificate obtained from an auditor certifying that the Guidelines have been fully met

To sum up, the Board of Directors of the company has to see whether the Articles of Association permits issue of bonus shares or not If it permits, the Board will have to pass a resolution for the same Then, the company will have to apply to the Controller of Capital Issues for the approval After obtaining his approval, the matter may be moved in the general meeting of the company and it has to be sanctioned in the meeting

Auditor's duties The auditor has the following duties in this connection

(*i*) He has to see the Articles of Association of the company to find out whether issues of bonus shares is permitted or not

(*ii*) He has to see the minutes of the Board's meeting and inspect the resolution in this connection

(*iii*) He will have to see whether the approval has been granted by the Controller of the Capital Issues or not For this, he will have to inspect the letter of the Controller permitting issue of bonus shares

(*iv*) He has to see the minutes of the annual general meeting of the company to find out whether it has been duly sanctioned in the meeting or not.

(*v*) The auditor may be called upon to issue a certificate as to whether the Guidelines issued by the Controller of Capital Issues have been met or not If so approached, he may be required to issue such a certificate

82 As an auditor, you are questioned in a general meeting of the shareholders as to why you should have signed the balance sheet when all the assets indicated therein are not shown at their realisable value ? What should be the nature of your reply ?

As an auditor, the reply may be given on the following line

(*i*) Broadly, there are three kinds of assets which are shown in the balance sheet of a company, viz, fixed assets, current assets, and intangible assets The allegation in the question is related more to the fixed assets as they normally do not realise the value with which they are shown in the balance sheet

(*ii*) The reason as to why the fixed assets are now shown or realisable or market value are as follows —(*a*) the fixed assets are purchased to increase the earning capacity of the concern and they are not purchased with a view to resell them They are to be maintained in the concern for a very long period The market value does not affect their earning capacity, therefore, it should not be taken into account, (*b*) even when they are to be shown at the market value, it will be a difficult task indeed Their market value can not be found unless until they are put to sale, (*c*) any effort to show these assets at the realisable value would amount to an endless exercise as no reliable basis is normally available for the purpose of finding out their realisable value Thus, the market or realisable value of these assets is ignored and they are normally shown at cost less depreciation

(*iii*) The provisions of the Companies Act, 1956 also requires that these assets should not be shown at their realisable value. Schedule VI to the Act requires them to be shown at cost less depreciation.

(*iv*) The intangible or nominal assets such as goodwill, also appear in the balance sheet, though there is no question of any realisable value for such assets. They are not assets in the real sense but they appear as a matter of practice and convention and also that they cannot be shown as items of expenditures in the accounts Thus, the question of showing them with realisable value does not arise

(*v*) The current assets are normally shown at the realisable or market value, even though their cost may be more than that The general principle for these assets is that they should be shown at cost or market value, whichever is lower It is only in case of debtors cost is no criteria because it is a receivable itch and represents the value of the claim that can be legally enforced Common practices and conventions also suggest that the various current assets should be shown at cost or market value whichever is lower

(vi) Thus, as a matter of practice, the accounts of a concern are maintained treating it as a going concern not as a concern going to be liquidated The common prudence also requires that this practice is correct Therefore, the various assets are shown in the balance sheet on the basis of certain principles based on above fact On this basis the principles, practices and conventions have developed by which we show various current assets at cost or market value whichever is lower as their realisability is relevant Whereas we show various fixed assets on the basis of cost less depreciation as realisability is not material in case of fixed assets. It is because they are to be used for a longer period to increase the earning capacity of the concern Therefore, the cost is more relevant in their case as it is incurred to obtain them

83 Distinguish between propriety and performance audit In which circumstances, would it be the duty of a statutory auditor to conduct also the performance and propriety audit ?

Performance and propriety audits are twin aspects of the management audit The need for such audit is increasing day by day as the size of the concern is increasing and grip a control over all the executives is not physically possible

The propriety audit refers to "an audit in which the various actions and decisions are examined to find out whether they are in public interest and whether they meet the standards of the conduct" In it, the auditor has not simply to see that the expenditures have been incurred and all the necessary vouchers are available for the same But he is required to see the 'propriety' of such expenses. The term propriety, in the words of Kohlar implies "that which meets the tests of public interest, commonly accepted customs and standards of conduct." Thus, 'wisdom' faithfulness and economy' of expenditures have to be duly looked into it The general principle applied under it is "that every public officer should exercise the same vigilance in respect of expenditure incurred from public money as a person of ordinary prudence would exercise in respect of expenditure of his own money" It implies that auditor has to question the rationale behind any expenditure and has to find that whether same results could have been obtained otherwise with greater economy and whether the rate and scale of expenditure were justified in the circumstances Such an audit has to be undertaken for verifying that there has not been any leakage of revenue, misappropriation of assets, or wastage of funds, due to a transaction or a group of transactions having been entered into either inadvertently or deliberately in disregard of any legal requirements or on economic or financial consideration. The propriety audit needs special investigation which has to be undertaken to find out that contracts, except those relating to the routine transactions, entered into with third parties, are in the best interest of the concern and that there is a system which ensures adequately the safety of the assets of the concern. It may be noted that the propriety audit has been normally undertaken in case of

government audit It is how being increasingly recognised that it has some place in audit of private concerns also.

Performance audit, on the other hand, is another audit function In fact, it is a procedure for (i) analysing the profits and losses of different economic activities in which the concern is engaged, (ii) determining the relationship between production and sales, (iii) determining whether the sales pattern has deviated from the one considered ideal, (iv) maximising profits, and (v) determining the imbalance, if any, in the inventory.

The Companies Act, 1956 has provided for duties of a statutory auditor under Section 227 These duties of auditors cannot be curtailed However, the shareholders are empowered to eotend them, if they like so They may, thus, extend the duties of an auditor so as to cover examination of the propriety aspects of transaction entered into by the company as well as the review of operational aspects of the company If the duties of the company auditor are so extended, he will have to extend his examination in these fields also

By the Companies (Amendment) Act, 1965, a sub-section (1A) was added to Section 227 of the Companies Act, 1956 Thus, it has now become obligatory for an auditor to enquire into the propriety aspects of six different types of transactions entered into by a company, as specified into the sub-section These transactions are as follows :—

(*a*) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members,

(*b*) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company,

(*c*) Where the company is not an investment company within the meaning of section 372 or a banking company whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company,

(*d*) Whether loans and advances made by the company have been shown as deposits,

(*e*) Whether personal expenses have been charged to revenue account,

(*f*) Where it is stated in the books and papers of the company that any share have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance-sheet is correct, regular and not misleading

In case, the auditor finds, through his enquiries, that some of the transaction entered into by the company are not in the best interest of the shareholders, it becomes his duty to report the fact to them The additional requirements prescribed under Section 227 (-A) of the Companies Act, 1956 also contains matters when propriety aspects need be seen

84 What is the significance of the provisions of Part II of Schedule VI to the Companies Act, 1956 requiring disclosure of the amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting ? Illustrate with examples

In case of the change in the basis of accounting, there may be impact on the working results of the company If the change in the basis of accounting in respect of any item shown in the profit and loss account bring about material effect on its working results, the law requires that it should be duly disclosed In this connection, the change affected as well as the effect of the change have to be disclosed The law has made this provision so that any such change may not make the accounts misleading Any material change, it may be noted not only affect the working results of the current year but it also affect the comparability of the data of the current year with those of the past That is why it has been made necessary to disclose it properly

Next question which arises in this connection is as to when can we say that the change is material This has, of course, to be judged by the auditor He will have to see what effect is there due to change in the basis of accounting For this he will have to compare the results with change and without change and then to see whether the effect is material or not The method of disclosure, however, is very simple For this, simply a note has to be given in the final accounts of the company

There are two important items in the profit and loss account of a company in which a change may bring about material effect They are : stock-in-trade and depreciation A change in the method of valuation of stock may bring about material change in the working results of the company. Similarly, a change in the method of charging depreciation may also bring about substantial and material impact on the working results of the company Therefore, it is quite necessary to disclose any change in the final accounts of the company so that anybody who examines the final accounts may not be duped by them The management is free to make such changes but law does not allow the management to bring about change to its own advantages only

85 Explain the concept of materiality in Accounts and discuss how far an auditor is concerned with ?,

What general points have to be kept in mind by an auditor in judging the materiality of an item ?

The principle of materiality is and has always been fundamental to the whole process of accounting An auditor has also to be quite

concerned with regard to the concept of materiality In fact, he has to analyse and take decisions regarding various items whether they are material or not during the course of audit This would require thorough knowledge, competence and experience on his part In case, he finds that an item is quite material in nature he would have to give careful consideration to its checking and would call for more evidences in support In fact, he would have to undertake an 'audit in depth' to satisfy himself regarding such material item

It is not very easy to define the term 'material' though it has been used very often in the statutes and other books Moreover, its meaning would differ in different circumstances The dictionary meaning of the term is "of serious importance, esp of legal importance" It implies that any item or transaction is material, if it is of serious importance under a given condition or auditing situation It would be for an auditor to apply his own discretion to decide whether an item is of serious importance or not in the circumstances of a particular case If the circumstances change, he would have to think afresh

In an accounting sense, an item may be taken to be material, if its non-disclosure, misstatement or omission would be likely to distort the view given by the accounts or other statements under consideration. It may be pointed out that arithmetical accuracy, although fundamentally important in accounting, is not itself sufficient to satisfy the legal requirements That is why the widest possible appreciation must be made and the consideration of materiality must be kept in view

Thus, every auditor must decide about the items to be material in the given situation and must include those items in his audit programme carefully so that they may be examined properly and in detail. If he is not careful about them, he may be held liable for the same

In the Companies Act, 1956, the word 'material' has been used on several occasions The Schedule VI attached to the Act requires that the financial statements should disclose all 'material items' so as to give true and fair view of the financial state of affairs of the company Part II of Schedule VI requires that the profit and loss account should disclose every 'material feature' What is material, however, has been left to the discretion of the accountant and auditor Any criteria to be adopted for the decision about the materiality, however, should be firmly based upon a real understanding of the full significance of the words 'true and fair' as introduced for the first time in the Companies Act, 1956 in place of words 'true and correct'

Similarly, the Second Schedule to the Chartered Accountants Act, 1949 also refers to it Clauses 5, 6, 8 and 9 of Part I of this Schedule refers to 'material fact, material mis-statement, material exceptions, and material departure from the generally accepted procedure of audit etc.'

Its importance has been underlined in the *Statements on Auditing Practices* issued by the Institute of Chartered Accountants of India It has been stated in it that the recommendations contained in it would "apply primarily to items which are material and significant in relation to the affairs of a company Items of little or no significance may be dealt with as may be found expedient, as it is neither desirable nor necessary that members should devote their time and energies in the pursuit of matters of a trivial nature However, freedom to deal expediently with non material items should not extend to a group of items whose cumulative effect on the accounts may be material and significant "

It is very difficult to lay down any general criteria or guidelines for determining what is material and what is not material However, certain generalisations may be made in this connection which would help an auditor to take decisions in this respect

(*i*) The question of materiality can arise in relation to (*a*) disclosure, including manner of disclosure , (*b*) correction of errors or omission , (*c*) methods of computation etc

(*ii*) Materiality has to be seen and judged only in relative context, and not in absolute term For instance, Rs 1,000 may be a material amount in case of a smaller concern whereas it may not be so in case of a large concern In the latter case, even Rs 10,000 may not material

(*iii*) Items of small amount are not necessarily insignificant, specially where they might have been expected to be larger Even a small amount may become material if its disclosure is essential statutorily For instance, payment made to the directors as sitting fee has to be disclosed precisely and separately

(*iv*) Several individually insignificant items might represent a material amount in total That is why it is necessary to see as to what is the impact of an items on the total of the category of items to which it belongs For instance, amount received as dividend would be material if it affects total amount of income from investment considerably

(*v*) Care should be exercised before offsetting items of opposite effect where each on its own right have been referred to as material, e g , a non-recurring loss against a profit arising from a change in the basis of accounting

(*vi*) While judging the materiality, the impact of the item concerned on the profit and loss account and the balance sheet also should be duly taken into account If the item is such that it would affect profit or loss significantly that should be taken to be material Similarly, if an item affects the financial position of the concern significantly that should also be taken to be a material one

(*vii*) Sometimes, the percentage comparisons may be made to judge the materiality of an item The Companies Act, 1956 itself has indicated it as an indicator of materiality For instance, Part II of Schedule VI to the Act requires that any item exceeding 1 per cent

of the total revenue of the company or Rs 5,000, whichever is higher, shall be shown as a separate and distinct item under an appropriate account head in the profit and loss account and shall not be combined with any other item to be shown under miscellaneous expenses

(*viii*) Comparison with the corresponding figure in the previous years may also serve to be useful indicator of materiality For instance, if the amount of an item is not significant this year but it was quite significant in the previous year, then that item would become material this year

(*ix*) While judging the materiality, it should also be seen whether items are capable of precise and accurate determination or not If it is so, even a small error in the same would become material But if the amount of a particular item is to be complied on the basis of estimation, a small error would not be material For instance, depreciation cannot be calculated correctly or precisely but can be simply estimated Therefore, an excess provision of the depreciation by Rs 100 or 200 would not be material

86 Describe the Additional matters to be stated in the Audit Report under Manufacturing and other Companies (Auditor's Report) Order, 1975 ?

Section 227 (4-A) of the Companies Act, 1956 provides empowers the Central Government to direct, by a general or special order, that in the case of specified companies the auditor's report shall include a statement on such matters as may be specified in such an order Under these provisions, the Central Government has issued the "Manufacturing and Other Companies (Auditor's Report) Order, 1975" The Order came into effect from January 1, 1976

This Order is applicable for the companies engaged in one or more of the following activities

(1) Manufacturing, mining or processing,

(2) supplying and rendering services,

(3) trading, and

(4) the business of financing, investment, chit fund, *nidhi*, or mututal benefit societies

It may be noted that the Order is not applicable for the banks

The Order requires that the auditor will have to include certain specified matters, described below, while giving report on the accounts of the examined by him and to which this Order applies The matter specified are different in case of the above-mentioned different companies

(1) *Manufacturing, Mining, or Processing Companies*

In case of manufacturing, mining or processing companies, the audit report should include a statement on the following matters

(*i*) Whether the company is maintaining proper records to show full particulars, including quantitative details and situation of fixed assets, whether the fixed assets have been physically verified by

the management, and if any serious discrepancies were noticed on such verification, whether the same have been properly dealt with in the books of account

(ii) In case any of the fixed assets have been revalued during the year, the basis of revaluation should be indicated

(iii) It should be examined and reported whether physical verification has been conducted by the management at reasonable interval or periods in respect of finished goods, spare parts and raw materials, and, if any significant discrepancies have been noticed on such verification as compared to book records, whether the same have been properly dealt with in the books of accounts It is to be seen whether the auditor is satisfied that the valuation of these stock is fair and proper in accordance with the normally accepted accounting principles and is on the same basis as in the earlier years If there is any deviation in the basis of valuation, the effect of such deviation, if material, is to be duly reported

(iv) In case the company has taken any loans, secured or unsecured, from companies, or firms or other parties listed in the register maintained under Section 301 and 370 (1—C) of the Companies Act, 1956, it has to be reported whether the rate of interest and the terms and conditions of such loans are *prima facie* prejudicial to the interest of the company

(v) It has to be stated whether the parties to whom the loans or advances in the nature of loans have been given by the company are repaying the principal amount as stipulated and are also regular in payment of the interest and, if not, whether the reasonable steps have been taken by the company for recovery of principle and the interest.

(vi) The statement shall include whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business for the purchase of stores, raw material, including components, plant and machinery, equipment and other assets.

(vii) In case, any stores, raw materials or components exceeding Rs 10,000 in value for each type thereof are purchased during the year from subsidiaries, firms or companies or other parties in which the directors are interested, whether the prices paid for such items are reasonable as compared to prices of similar items supplied by other parties

(viii) It has to be examined and stated whether any unserviceable or damaged stores and raw materials are determined and whether provisions for the loss, if any, has been made in the accounts

(ix) In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India, and the provisions of Section 68 A of the Companies Act, 1956, and the rules framed thereunder, wherever applicable, have been complied with

(*x*) Whether the company is maintaining reasonable records for the sale and disposal of realisable by-products and scraps where applicable and significant

(*xi*) In case the paid-up capital of the company at the commencement of the financial year concerned exceeds Rs 25 lakhs, it has to be stated whether the company has an internal audit system commensurate with its size and nature of its business

(*xii*) Whether the maintenance of cost records has been prescribed by the Central Government under Section 209 (1) (d) of Companies Act, 1956, whether such accounts and records have been maintained

(*xiii*) Whether the company is regular in depositing the provident fund dues with the appropriate authorities and, if not, extent of arrears of provident fund dues shall be indicated by the auditor

(2) *Companies Supplying and Rendering Services*

For the companies supplying or rendering services, or service companies, the following additional matters have to be reported

(*i*) All the matters specified under (1) above to the extent as to which they are applicable

(*ii*) Whether the company has a reasonable system of recording receipts, issues and consumption of materials and stores commensurate with its size and nature of business and whether such system provides for a reasonable allocation of the materials and man-hours consumed to the relative jobs

(*iii*) Whether there is a reasonable system of authorisation at proper levels with necessary control on the issue of stores and allocation of stores and labour to jobs and whether there is any system of internal control commensurate with the size of the company and the nature of its business.

(3) *Trading Company*

In case of a trading company, the following additional matters have to be stated in the auditor's report

(*i*) All the matters under (1) mentioned above, to the extent to which they are applicable

(*ii*) Whether the damaged goods have been determined and if the value of such goods is significant, and whether the provisions have been made for the loss

(4) *Finance, Chit Fund, Nidhi, or Mutual Benefit Companies*

In case of companies engaged in the business of finance, chit fund, *nidhi* or mutual benefit, the following additional matters have to be reported

(*i*) All the matters specified under (1) mentioned above, to the extent to which they are applicable

(*ii*) Whether adequate documents and records are maintained in a case where the company has granted loans and advances on the

basis of security by way of pledge of shares, debentures and other similar activities

(*iii*) Whether the provisions of any special statute applicable to chit fund, *nidhi*, or mutual benefit society have been duly complied with

(*iv*) If the company is dealing or trading in shares, securities, debentures and other investments whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein. Also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of the exemption, if any granted under Section 49 of the Companies Act, 1956

It may be noted that the Order stipulates that in case auditor gives unfavourable or qualified answers to any of the questions on which a statement is required to be included in his report, the reasons for such answers should also be stated by him in clear words In case he is unable to express any opinion in answer to a particular question, his report would also indicate this fact He should also mention the reasons why it is not possible for him to give an answer to the particular question

It may also be pointed out that if an auditor gives qualified answer to such questions that would not necessarily make his opinion on the truth and fairness also qualified, unless, of course, the qualified statement is such that it affects the working results or the financial condition as disclosed by the profit and loss account and the balance sheet

87. Does Manufacturing and other Companies (Auditor's Report) Order, 1975, Amount to Social Audit ?

After the issue of the Manufacturing and Other Companies (Auditor's Report) Order, 1975, there has been a controversy whether this is a social audit ? It was thought that it has extended the scope of audit considerably and it has now made the auditor more responsive to the needs of the society and as such this has been taken to be a social audit But this is not wholly true In fact, the social audit has much wider implications and that "encompasses an assessment of what a company contributes to the society and what it takes away from it".

It gave rise to such a controversy on account of the fact that when this Order was promulgated it was stated that it was introducing "regulatory social audit" The object of such Order was also stated to be "to ensure that the social objective of company audit by chartered accountants is achieved in a greater measure, considering the basic fact that under modern conditions, companies have to subserve public interest rather than purely private gain of the investors." Thus, it would help in introducing social audit to some extent but to call it social audit would be a bit exaggeration We may say that it is a step towards that In fact, the chartered accountants have to read the writings on the wall and should see

that the public interest is also to be safeguarded as much as possible However, it would take a long way to undertake social audit, specially in a country like India where the auditors have yet to be conscious of this fact

It is notable that some of the obligations of the auditor as introduced in the Order, have already been assumed by the many firms of auditors With the passage of time, the auditors have started undertaking more careful examination of the accounts rather than simply undertake what is known as ' verificatory audit'' With the growth of large number of Central Government and State Government undertakings in the country, the auditor is becoming conscious of this fact and is changing their attitude accordingly

It has also been pointed out that "Some of the additional matters on which the auditor has to make a statement in his report under this Order represent merely a statutory recognition of what were already recognised as standard 'auditing practices" It has been further pointed out that the "auditing procedure as discussed in the *Statement of Auditing Practices* issued by the Institute of Chartered Accountant of India, is more or less similar regarding stocks and fixed assets to what is implied in this Order Similarly, matters relating to the verification of certain aspects of internal control do not require a substantially new procedure of auditing "

88 Discuss the concept of management audit and need for the management audit.

Management audit is of quite recent origin as compared to that traditional verificatory audit. With the growing size and complexity of business organisation and more and more professionalisation of management, the need arose for the review of performance of management itself With this grew the concept of management audit

Management itself is a complex process and management audit implies an attempt to evaluate the performance of various management process and functions It is an audit to examine, review and appraise the various policies and actions of the management on the basis of certain objective standards" Thus, management audit involves a detailed and critical evaluation of as to what has been done by the management

The Federal Financial Officers' Institute at Canada has defined the concept and scope of management audit in the following words "A systematic independent appraisal activity within an organisation for a review of the entire departmental operations as a service to the management The overall objective of operational auditing is to assist all levels of management in the effective discharge of their responsibilities by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed It may be pointed out that some authorities take operational and management audit as synonym while others make a distinction between the two However, the two may be taken to be synonymous.

The standard practices followed for the purposes of traditional audit would require some additions, deletions and modifications as the management audit would require an entirely different approach In fact, it is a difficult task and would require mature experience, thorough knowledge of management principles and practices and a critical, analytical as well as constructive bent of mind It is not very easy to examine and evaluate the policies pursued and actions taken to achieve the pre-determind objectives The independent management auditor would have to find out and analyse the reasons for inefficiencies of management, if any However, his approach has to be quite constructive so that his examination may not stifle the initiative of management in future

The management audit, may involve following important steps to be taken

(i) It would necessitate the identification of goods and objectives of the organisation

(ii) The auditor would have to see as to how the overall objectives have been broken into sub objectives, plans and targets etc

(iii) He will have to examine critically the structure of organisation pin-pointing the centres of responsibility, allocation of duties and delegation of authority etc

(iv) He would have to examine the performance in different areas with those of the pre-determined standards It should also be reviewed with the help of past performance and performance of similar organisations

(v) After a thorough and analytical examination of policies, plans, targets and achievements etc, he should work out the constructive suggestions in the areas, where necessary, so that the performance may improve in future

The need for management audit arises on account of the following main reasons

(i) It helps in improvement of performance of the various managers, as the independent auditors offers valuable and constructive suggestions for their improvement The general manager or the managing director is normally not in a position to make such objective study and analysis independently, as he is too much involved in the organisation itself

(ii) The size and complexity of organisation is increasing day by day and often it is not possible to make such studies

(iii) Such review of the performance of managers may become necessary when the management desires to provide some sort of incentive and link that with that of performance

(iv) The Government is often forced to undertake the management audit with a view to find weaknesses and inefficiencies of management This has often become necessary in our

country as the number of sick mills is increasing causing great economic and social loss.

(*v*) The financial institutions and banks may require such management audit to be undertaken when they are either willing to lend huge funds to a concern or when they want to review the progress of the concern whom funds have already been given

(*vi*) Foreign collaborators often undertake management audit periodically to assess the progress and performance of management of the concern with whom collaboration has been undertaken They might be interested in seeing that their investment is being utilised fully and there is no wastage

(*vii*) There is a need for undertaking management audit in case of public enterprises, specially where management has been following bureaucratic approach and emphasis might be on following the rules and procedures rather than on achievements and results They have to be suggested to change their outlook to improve the over all efficiency of the concern.

There is a misconception that management audit may simply stifle the initiative of management On account of fear of being caught on the wrong foot by others in future, they might not take risky decisions and might follow the practices of Government officers to follow rules and procedures more and bother less about the results But such a concept is quite misleading, as management audit does not involve examining whether rules and procedures have been followed or not It implies evaluating the actual performance of managers and finding out whether pre-determined standards, targets and plans have been achieved or not It does not involve at all finding out that rules and procedures have been followed or not Thus, it is a very potent tool for the assessment of performance of management

89 Discuss the concept and object of Cost Audit and state who can conduct it under the Companies Act, 1956

Cost audit is a new concept and it has been recently introduced by an amendment in the Companies Act in 1965 Such audit has to be carried on in addition to the financial audit of the company normally conducted The Central Government has assumed power to direct audit in case of companies engaged in production, processing, manufacturing or mining activities etc

The cost audit may be described as "an independent and critical examination of the various cost records, maintained by the company with the objective of ascertaining that the costs of the product or products manufactured by the company have been accurately determined in accordance with the correct principles" Thus, it would involve an independent and critical examination of—(*i*) the statements prepared for computation of cost , (*ii*) records enabling preparation

of such statements, (*iii*) principles, whether they have been correctly applied

The various objectives with which such cost audit of a particular company may be ordered by the Government have not yet been described clearly It may, however, direct for such audit with the following objectives

(*i*) To find out accurate costs of the products of a company to whom the Government has given a contract

(*ii*) To determine whether a company should be allowed to charge special price with a view to promote expansion

(*iii*) To ascertain cost of a company before granting protection by the Tariff Commission

(*iv*) To fix prices of commodities of national importance

(*v*) To curb profiteering by monopolistic companies or to check inefficiences of certain companies

(*vi*) To nail down generalised comments of high selling prices or inefficiency

(*vii*) To determine responsibility in case a company is run prejudicially to the interests of its shareholders in particular or the consumers in general

Under Section 233-B of the Companies Act, 1956, cost audit may be conducted by—(*i*) Cost Accountants within the meaning of the Cost and Works Accountant Act 1959, or (*ii*) Chartered Accountant, or (*iii*) Other persons, possessing the prescribed qualifications

90. If called upon to conduct cost audit of a company, state briefly how would you proceed

For conducting cost audit of a company, we should—

(*i*) Ascertain the system of cost accounting in use in the company

(*ii*) Enquire the degree of efficiency with which the system is being enforced and the degree of accuracy of the records with a view to decide the extent of examination Note down the weaknesses or limitations of the system operated

(*iii*) Check various cost records as exhaustively as possible Adopt test checking if the system is efficiently enforced and we are satisfied with the same

(*iv*) Check material records as follows

(*a*) examine postings of materials received, notes and issue requisition with reference to various material accounts in respective Ledgers

(*b*) enquire the basis of pricing of issue requisitions and their classifications into direct and indirect materials

(*c*) ascertain that requisitions of direct materials have been posted with reference to cost sheet

(*d*) check a good number of Materials Issue Requisitions into

Materials Issued Summary Test Check returns or materials to stores and their transfers from one job to another

(e) ascertain agreement of the total issue of direct materials charged for the period in cost records with the total issues for the same period as disclosed by the financial records

(v) Examine Labour Records carefully as follows

(a) Check timings as shown in Job Cards, Time Sheets or Wages Tickets with relative Clock Cards Check amount of wages entered into their Direct Labour Abstracts

(b) Check postings into Job Cost Ledger

(c) Enquire how labour expended spoilt works is recorded Also see authorisation of overtime to workers and how the time has been dealt with

(d) Ascertain that direct and indirect labour cost has been properly classified and recorded

(e) Reconcile total direct labour cost as shown per various cost sheets with the aggregate labour cost as per time summaries and Financial Accounts

(vi) Check overhead cost records carefully and ascertain the basis adopted for their application and ensure that they have been correctly recorded accordingly

(vii) Compare the aggregate overhead costs as shown in various cost sheets with the actual overhead expenses Account for over or under applied overheads

(viii) Examine the basis or valuation of work-in-progress and other inventories very carefully Check the inventory of finished goods with the finished stock account in the Cost Ledger

(ix) Account for wastage of labour and materials on account of which the cost might have increased

(x) Ascertain whether machines were fully utilised or under-worked and the reason therefor Check the installed capacity of production with actual production

(xi) Compare the actual cost with the standard cost and see whether any system of budgetary control has been applied. Compare also the cost of the current year with that of previous years and seek explanations for material differences, if any

91 Bring out the new requirements of recent amendments to Schedule VI, Part I and II of the Companies Act, 1956.

The present amendment to Companies Act, 1956 was notified in the Extraordinary Gazette of India dated November 9, 1973 and is applicable to accounts ending on or after that date

The scheme of the present amendment can be considered as an extension of the scheme of amendment brought out in 1971 to the VIth Schedule

The whole scheme of recent amendment to Schedule VI centres round supplementing the financing information contained in the statements of account by qualitative information as an integral part of financial statements For a better understanding of financial information, the amendments provide for suitable classification of sales, distinct disclosure of raw materials consumed item-wise for a manufacturing company, break-up of opening and closing stocks of goods produced and traded in respect of each class of goods, etc

The specific new requirements in the present amendment are as follows

Balance Sheet

(*i*) Investment in the capital of partnership firms has to be shown separately under 'investments'

(*ii*) Advance and loans to partnership firms in which company or any of its subsidiaries is a partner should be separately disclosed under the heading 'Loans and Advances'

(*iii*) The annexure containing the statement of investments in terms of note (l) under the form of Balance Sheet in VIth Schedule should also contain details about the names of the firms in which investments have been made, the names of the partners therein, the total capital of the firm and the shares of each partner.

Profit and Loss Account

(*i*) The turnover shall be given in respect of each class of goods dealt in by the company alongwith the corresponding qualities of goods sold

(*ii*) In case of a manufacturing company, the value of raw materials consumed, giving item-wise break-up together with the quantities thereof However, the intermediates and components procured from other manufacturers may be grouped together and their quantities need not be given, if their individual values are below 10 per cent of the value of raw materials consumed

(*iii*) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods with the corresponding quantities

(*iv*) In respect of trading companies, the purchase and opening and closing stocks, giving values and quantities for each class of goods traded in

(*v*) In respect of companies rendering services, the gross income derived from services

(*vi*) Break-up of expenditures incurred on employees who, working throughout the year, received a remuneration of Rs 36,000 or more for the year and on employees employed for part of the year received at a rate not less than Rs. 3,000 per month The number of employees falling in each category should also be given.

(vii) Separate disclosure of such miscellaneous expenses which exceed the higher of 1 per cent of the total revenue for the year or Rs 5,000

(viii) Profits or losses earned or incurred on account of membership of a partnership firm

(ix) In respect of a manufacturing company, quantitative information for—

(a) the licensed capacity ,

(b) the installed capacity ,

(c) the actual production should be given by way of note

(x) Also by way of note, the following information should be given

(a) value of imports, calculated on c i d basis, of raw materials, components and spare parts and capital goods

(b) Expenditure on foreign currency during the financial year on account of royalty, know-how, professional consultation fees, interest and others

(c) Value of all imported raw materials, spare parts and components consumed during that year Also the value of indigenous raw materials, spare parts and components similarly consumed and the percentage of each on the total consumption

(d) The amount remitted during the year in foreign currencies on account of dividends with the specific mention of number of non-resident shareholders, their shareholding, and the year to which the dividend is related

(e) Earnings in foreign exchange classified under

(1) Export of goods calculated on F O B basis,

(2) royalty, know-how, professional and consultation fees ,

(3) interest and dividends, and

(4) other incomes, indicating the nature thereof

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